PROCEEDINGS

OF THE EIGHTH ANNUAL

Institute on Accounting

Held at

THE OHIO STATE UNIVERSITY

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Sponsored by

THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
THE OHIO STATE UNIVERSITY

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THE BUREAU OF BUSINESS RESEARCH
THE COLLEGE OF COMMERCE AND ADMINISTRATION

FOREWORD

The Eighth Annual Institute on Accounting marked the resumption of this series, broken only by cancellation in 1945 occasioned by wartime travel restrictions. It was very gratifying to the members of the Department of Accounting to again welcome to the campus a very large and enthusiastic audience.

Deep appreciation is expressed to the speakers, and to the organizations which they represented, in contributing to the program on "Accounting for Free Enterprise in the Reconversion Period and After."

The organizations which contributed generously to the outstanding success of this Institute by providing speakers were:

The Ohio Society of Certified Public Accountants
The American Accounting Association
The American Institute of Accountants
The Controllers Institute of America
The Institute of Internal Auditors, Inc.
The National Association of Cost Accountants

Of these, The Controllers Institute of America and The Institute of Internal Auditors, Inc. were represented for the first time. Special welcome is extended to the members of these organizations which have joined the family of accounting associations participating in the Annual Institute on Accounting at Ohio State University.

The Department of Accounting announces the dates for the next, the Ninth Annual Institute on Accounting, on May 16 and 17, 1947. Plans are being made for a special occasion at that time marking the 25th anniversary of the expansion of the College of Commerce and Administration to a full four-year curriculum. We hope to see all who have attended any of the past annual Institutes and many newcomers to the series.

THE DEPARTMENT OF ACCOUNTING
The Ohio State University

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FIRST SESSION

FRIDAY, MAY 17, 1946—10:00 A. M.

Commerce Auditorium

Chairman:

ROBERT N. LLOYD, C.P.A., *Dayton, Ohio; President, The Ohio Society of Certified Public Accountants*

Address: "Organization for Effective Auditing"

CURTIS T. ATKISSON, *Ebasco Services, Inc., New York; President, The Institute of Internal Auditors, Inc.*

Address: "Organization for Effective Profit Control"

D. M. SHEEHAN, *Comptroller, Monsanto Chemical Company, St. Louis, Missouri; Vice President, Controllers Institute of America*

INTRODUCTORY REMARKS

By Robert N. Lloyd, C.P.A.

Lloyd and Shields, Dayton, Ohio
President, The Ohio Society of Certified Public Accountants

It is again our privilege to attend the annual Institute on Accounting. I take great pleasure in welcoming you, on behalf of the Ohio State University, to this eighth annual meeting. The University has graciously arranged these annual meetings during the past nine years, being forced to abandon plans for such a meeting last year, due to transportation difficulties. I hope, and I know you, too, hope that the conditions which have existed these past few years will not be encountered again.

In looking over the registration, I find that we have in attendance, members of

The Ohio Society of Certified Public Accountants
The National Association of Cost Accountants
The Controllers Institute of America
The American Institute of Accountants
The Institute of Internal Auditors
The American Accounting Association, and
The American Society of Women Accountants.

Therefore, you can see, we have quite a representative group.

During the war and in the immediate post-war era, the accountants' duties were concerned chiefly with the determination of the cost of producing war products, the renegotiation of war contracts, the termination claims, the determination of the proper taxes due the government, the section 722 claims, the carry-over and carry-back provisions, etc. Every branch of government, including Federal, State, and local, has issued rules and regulations affecting our work. These are found in codes, statutes, riders to various bills, executive orders, directives, administrative decrees, formal regulations, interpretative bulletins, official questions and answers, and even in press releases. Many others are the Bureau's own policies and procedures which are not public information. These rules and regulations were always plagued with exemptions, exceptions to exemptions, exemptions to exceptions, and other special rules. Most of these are still with us, even though the war ended nine months ago. A considerable amount of our work, pertaining to the war, has been completed, but there is more to be done and, no doubt, some of these cases will be dragging through the courts for several years to come.

The trend of accounting has now changed from that of accounting during war-time to accounting for free enterprise. Our duties are now concerned with assisting management to operate businesses successfully by providing proper accounting information. Management, now more than ever before, must rely on the vast amount of informaton which we are in a position to furnish.

We, as accountants, in order to furnish management with the proper information, must find new and effective means and methods for securing such information. Our work is not static. It must advance. We must find effective methods of audit control and profit control. We must give support to a sound tax policy, one that will permit free enterprise to survive. Also, we must furnish intelligent financial reports for stockholders and management. Many of management's activities are controlled by outside pressure groups. Particularly is this true in the fields of labor relations and price control. Inasmuch as costs, prices, and profits have been prominently mentioned in public discussions as issues in current disputes, the accountant is placed in a very unique position.

If private free enterprise is to remain, we must make it work, not only politically but economically. All the problems considered management functions are also problems of the accountant. Our speakers for today and tomorrow will give us much valuable information that will help us become conscious of our jobs. The general theme of the eighth annual Institute in Accounting, "Accounting for Free Enterprise in the Reconversion Period and After," has been chosen with the hope that it will help prepare us for the task that lies ahead.

I am pleased to present to you Mr. Curtis T. Atkisson of Ebasco Services, Incorporated, New York City, and President of The Institute of Internal Auditors.

ORGANIZATION FOR EFFECTIVE AUDITING

By Curtis T. Atkisson

Ebasco Services, Inc., New York City
President, The Institute of Internal Auditors

The subject assigned me deals with only one important phase of internal auditing, and my remarks will be devoted largely to that phase—organization. Before getting into the main discussion it may be well to define internal auditing, to give the definition I have adopted for this purpose. It is taken from *Managerial Control Through Internal Auditing,* a volume published by The Institute of Internal Auditors in 1943. The definition reads:

> Internal auditing may be defined as the organized activity on the part of management to assure itself proper adherence to company procedures and policies, and to secure the benefits of a systematic and objective verification and constructive analysis and appraisal of the accounting, financial, and other aspects of the company's operations.

As indicated by the title of the volume and the definition, modern internal auditing is not just a matter of routine proving of mathematical accuracy. Though internal auditing does not ignore the underlying responsibilities of all auditing—the determination of accuracy and reliability—it uses these basic processes only as a starting point for an additional and even more important contribution—constructive analysis and appraisal. Internal auditing is in a healthy, seething state of self-examination and development. Hundreds of concerns have installed internal auditing departments in recent years, and hundreds of others have reorganized auditing departments long established.

As an example that will interest you, I might mention that recently I talked with a responsible officer of a company one hundred and two years old, with assets of nearly two billion dollars, and learned that that company was one hundred years old before it had an internal auditing department. This is not to say that the concern had survived and prospered so long without internal controls and some internal auditing of sorts, but the internal controls were predominantly of the type that consists of letting one department check another by performing the operation twice—a very effective control but one which is now being rapidly replaced by more modern methods, involving, among other things, application of accounting machines and internal auditing by test verification, with attendant substantial expense savings.

As a much less horrible example—and perhaps a more usual case—the assistant controller of a large, nation-wide manufacturing and distributing concern somewhat sheepishly told me that several years ago he left a public accounting firm to set up a well-organized internal audit department for this company. The department is not yet organized. First a refinancing program had to have priority; then the war came and real priority trouble started; first one thing then another. The initially small audit staff was depleted by the war but the concern continued the work by supplementing the audit staff with occasional help on field assignments from members of their own general accounting office, by closely coordinating work with their public accountants, and by confining the internal auditing to bare essentials.

This man intends to, and undoubtedly will, remedy as soon as possible what he considers an unsatisfactory situation. He considers his situation unsatisfactory principally because he does not have an internal audit staff adequate for auditing operations, for the more constructive high-grade work that he believes it will pay his company to demand of its audit staff.

Another internal auditor, with whom I discussed my subject, made the observation that the first principle, or essential condition of organization for effective auditing, was that the internal audit organization meet the needs of the particular company. No doubt he offered this trite first principle, this truism, with the thought that it bears repeating, or perhaps his purpose was to head off any thought I might have had of giving you a simple prescription, of my own preparation, to be taken for any of the aches and pains of internal auditing. As a matter of fact, his statement is one of the few positive statements I shall make or endorse. I shall add only that it is understood, and is to be emphasized, that the internal audit organization must meet the *present* needs of the particular company.

The place of the internal auditor, the internal auditing department in the company organization, or the internal auditor's responsibility in reporting have been discussed extensively in the literature of The Institute of Internal Auditors. It seems to be a subject in which someone is always interested. Its importance is such that it might well be emphasized by saving it for my last point. However, as it is in some ways a rather delicate subject, I will tackle it and have done with it.

Should the internal auditor report to the board of directors, the president, a vice president, the controller, the treasurer, or to whom? May I at once categorically deny the rumor that leaders in The Institute want the president to report to the internal auditor. I have noted, with some interest, that lots of talk can be made on the subject of whether the advertising manager should report to the sales manager, the vice president in charge of sales, or to the president; similarly, with respect to the director of public relations; and similarly, with respect to the director of personnel, the director of employee relations, the placement manager, and so on.

All of the types of reporting responsibilities mentioned are included among the internal auditors with whom I have discussed this question. Each, almost without exception, found his own situation in this respect quite satisfactory. If, in practice, one arrangement so often works just as well as another, perhaps, because the actual responsibilities of positions with the same title vary so widely, and because the active cooperation of the key people in the management group is ordinarily such an important element in the success of the auditing department's efforts—if all this be true, what difference does it make to whom the internal auditor reports? And in what way is the internal auditor in any different position from other staff executives ready to demonstrate the validity of their claims to the ear of top management?

The internal auditor's responsibility to report direct to the board of directors has much to be said for it, and particularly where directors are acutely aware of their responsibilities to other groups as well as to stockholders. But the board of directors can, and not infrequently does, specify a certain minimum audit program on which the internal auditor is to be responsible for reporting to the board, while at the same time leaving the internal auditor free to carry on its role as a tool of management. As the president is the active head of the management, the internal auditor ordinarily would seem to be in the best position for maximum usefulness when he reports to the president, or to one of the president's assistants of true vice-presidential rank, regardless of title. The essential element seems to be to so place the internal auditor in the organization as to assure his reporting to an individual who is in a position to consider the auditor's reports objectively from the standpoint of the company as a whole, rather than departmentally.

Many internal auditors are not now so placed and, probably in most of these cases, the internal audit function is suffering no actual disadvantage. However, the potential disadvantage is there and a change in circumstances, such as a change in individuals occupying key positions or the disruption of favorable personal relationships, may cause it to become an actual disadvantage. Obviously it is not appropriate nor practicable to attempt immediate correction of all these theoretical defects in organization. Time itself will take care of many situations. Education and discussion and, of course, improvement of the grade of work done by the internal audit department—all will have their effect in helping internal auditors toward their proper goal of a place which assures authority to investigate, to the extent their judgments dictate, all phases of their companies' operations, field and general office, and to report their findings.

I have encountered an interesting example of what may be termed "the evolutionary correction of theoretical defects in the reporting responsibility of the internal auditor." Within the past few years the general auditor of a large organization was promoted to fill the job of his immediate superior, that of assistant controller. In connection with this change the former general auditor recommended (and his recommendation has been put into effect) that the general auditor report direct to the controller!

While the correction of theoretical defects in the reporting responsibility of the internal auditor may well be evolutionary, this is not to condone temporizing with situations where the defect is actual and where immediate corrective measures are indicated; nor is it to condone procrastination or repeated failure to take advantage of favorable opportunities for correcting long-continued, theoretical defects in the internal auditor's reporting responsibility.

The task of organizing for effective auditing is at least half done when you have a competent man to head the internal auditing department, and have given him appropriate authority and responsibility; but there are other problems, too. Among the questions that usually arise in the organizing or reorganizing of an audit department—a question any large organization would do well to review periodically—is the extent to which the audit staff should be centralized or decentralized. This topic alone warrants an extended discussion. In fact, the Policyholders Service Bureau of the Metropolitan Life Insurance Company made inquiry of a number of Institute members a year or two ago and prepared a special report on this subject.

It may be sufficient for present purposes to raise the question and indicate some of the possibilities. A mining, smelting and manufacturing organization finds a satisfactory solution for its purposes in two entirely independent internal audit staffs, one in the East where the principal audit problems are on large manufacturing plants, and one in the West where the problems relate principally to mining and smelting. In neither case do any of the plants, branches or subsidiaries have a local audit staff of their own, the auditing responsibility has been centralized in the two staffs.

One nation-wide oil producing, refining and distributing organization has a centrally controlled audit staff, but within the past two years, the company has divided the country into auditing districts and has assigned its staff members to the various districts with the understanding that their work will be within the district for a period of about two years. One of the principal objectives was to enable the audit staff members to have a home location. With this arrangement they can expect to be at home at least sixty per cent of the time. This company, in addition, has a staff of stock auditors permanently attached to each of the various marketing areas.

Another nation-wide oil producing, refining and distributing organization has a staff that works out of New York and one that works out of San Francisco, covering territory west of the Rockies. In this case, however, each marketing-area headquarters also has a local audit staff that checks stock and records of the various branches in the area.

For the auditing of several plants located some distance from the main office, a heavy machinery manufacturer now relies principally on a resident auditor in each plant. The resident auditor is responsible to the general auditor in the same way that the plant controller is responsible to the controller, although both are administratively responsible to the plant manager.

A large automobile manufacturer has a similar arrangement for plant auditors, with perhaps more emphasis on the responsibility to plant management, but, in addition, the general auditor has a staff of auditors who travel out of the general office. They are responsible direct to him for review of the work of the plant auditors and, in some cases, of the local auditor staffs of certain subsidiary companies.

Many considerations govern these arrangements. Among the considerations of significance brought out in my recent discussions of the subject were (1) ability to use on local audit staffs men with a less broad educational and experience background, since in some situations, the bulk of the work can be reduced to a highly specialized routine, (2) desire to minimize the difficulties inherent in work that requires long periods away from home, (3) desire to make the auditing department's arrangements conform to the company-wide organization.

From where do the auditors come in this organization for effective auditing? In what proportions should different elements of the staff be maintained? Here again much seems to depend on the conditions applicable to the particular company.

The general auditor of a company operating three or four very large manufacturing plants which required a resident audit staff in each plant and in the main office, has experienced no difficulty in recruiting to the audit staffs the more outstanding men from the plant and main office accounting and cost-accounting staffs. Others have had little success with this method; still others feel that about half their audit staff recruits should come by this route, and half from employment of auditors who have gained their experience as senior auditors elsewhere.

Some companies employ nothing but seniors on their staffs. Others prefer to have as many juniors as seniors so that assignments can be made to teams of pairs, with a junior to do some of the detail work. Although working in pairs may be inefficient in some respects, thi sfactor is more than offset by the fact that company on an assignment and opportunity to talk over problems of the assignment makes for more effective work in the long run.

One company has what it believes is a most effective means of audit-staff recruitment; it is at the same time an important adjunct to the company's training program and it might be called a world-beater for getting the desirable feature of a fairly steady flow of new blood through the auditing department. This auditing department's staff consists of a large proportion of men who are borrowed—lend-leased—from the field organization for a period of two years. The auditing department manager has been able to convince these men, and the field executive involved, that two years in the auditing department will be the best training possible for their development and advancement. The aim is to return the men, at the close of the training period, to a position one or two grades higher than the one they left.

Experience to date indicates that this plan has been quite successful from the standpoint of the men, the auditing department, and the field organizations. Some unusual talent has been discovered and added to the main office organization, and the men returned to the field organizations appear to be developing rapidly under the impetus of the broad knowledge of the company's operations gained during their service in the auditing department.

Although the men selected for this training period in the auditing department generally have had little or no auditing experience, they have had accounting or operating experience that assures their being useful members of the staff. Assignments are handled by teams of three men.

This makes possible some specialization on particular assignments and provides opportunity for the trainees to work with and learn from others. Generally, these men are in charge of at least one assignment before completing their training period.

Thus far my remarks have given some indication of the various possibilities of the location and composition of the auditing-department staff. These matters have a bearing on the internal organization, the supervision, and the control of the audit staff. I will limit further remarks on this subject to two matters which seem to me to be particularly important: first, the preparation of an annual agenda or program of audits, and second, the budgeting of time for the planning or staff functions in the department.

When considering the mechanics of internal audit supervision, the preparation of an annual agenda or program of audits takes a top place. Well-organized audit departments include on the agenda for the coming year not only all the assignments considered necessary, but also the names of the persons who will cover the assignments, and the dates each assignment will begin and will be completed. The individual assignments and dates are naturally quite tentative and subject to such changes as become necessary. Due to unpredictable factors inherent in the work, some companies have a particularly difficult time to keep to the schedule. They find it especially important to prepare a schedule which will give advance information in regard to the need for adjusting the staff and the year's program to a practicable basis. During the year, when the schedule gets out of gear, the planning already done can be a basis for adjusting the schedule and for covering the "must" part of the program with a minimum of confusion. I noticed that one company's agenda was on a June-to-June basis, a plan which seems to have some advantages in that it avoids planning during the busiest time of the year and allows the making of audit assignments after vacation plans have become known.

And now, let us consider the budgeting time for the planning or staff functions in the department. From the viewpoint of the company as a whole the entire auditing department carries on a staff function; nevertheless, within the auditing department the time spent on audit assignments may be viewed as line operations, and the various matters that must be handled in arranging the assignments and in maintaining a flow of well-directed, successfully-completed assignments can be viewed as staff work which the internal auditor delegates in part to an assistant department manager or to staff assistants. A clear view of the matter is perhaps best obtained by a study of the organization of a large internal audit department; but the problem is present and a solution, similar in principle, is possible even with the small department.

Although the management principle is elementary and well known, it is not always easy to put into practice. When the audit schedule is lagging, it is difficult to take time—or to have a senior auditor take time—to study some parts of the audit program and procedure. Yet, had this been done a year ago, the program and procedure might have been revised so that now the schedule would be up-to-date. It would then be a simple matter to spare a man to review the possibilities of introducing into the audit program and procedure more constructive work. The auditors would then be remembered by the local and main office managements for the service they performed.

The vicious circle just inferred has undoubtedly, in some instances, prevented and delayed the making of adequate provision for the staff function in internal audit departments. However, judging from Institute literature and my discussions with internal auditors, many well-organized, internal audit departments make specific provision for the staff function, and they bear testimony to its benefits. Among the benefits may be listed such things as: auditing instructions covering all assignments, not just some of the assignments, with adequate provision for periodic review and revision; attention to the standardization of work papers; closer coordination with the external auditor's work; more attention to development of the constructive or operating phases of the auditing program; better ability to handle important special investigations which occasionally come to the internal audit department; and time for the internal auditor to give proper attention to work with top management committees and, otherwise, to lend his experience and the facilities of his department to the solution of major problems of the business.

One problem is that of the various functions which are frequently attached to the auditing department and which, with varying degree of certainty, can be said to be non-related functions. For example, the discussion within the forums of The Institute of Internal Auditors has been generally to the effect that modern internal auditing, as such, is a post-audit function having no part in the day-to-day accounting. The routine review, or auditing of current vouchers, is considered a part of the internal control in the accounting department. Some internal auditors, or general auditors as they are often called in such cases, are apparently convinced of the validity of this principle and of its applicability to their situation, but they have admitted, with due apology, that they have in their department a group which currently checks or audits the vouchers. The practice, which they expect or would be glad to change, is a carry-over from earlier days. On the other hand, some internal auditors point with pride to the advantages to their company in maintaining in the auditing department a current audit of vouchers.

Less frequently encountered, and in a somewhat different class, are the cases where the auditing department is called the audit and systems department or simply the audit department, but has responsibility for systems and methods, nevertheless; or where the auditing department has a division that is responsible for the company's plant and property records, with a complement of property inventory men; or where a bank's auditing department has a division that handles all routine complaints and adjustments with depositors and customers. Often, it appears in such cases that the adjunct to strictly auditing functions has been acquired by the auditing department because of its initiative in straightening out an unsatisfactory condition, because men of the required ability are in the auditing department, or because, for other reasons, the auditing department appeared to be the logical one to handle the function. Also, it not infrequently appears that the auditing department derives a certain amount of deserved prestige from the handling of the adjunct function and, thereby, greater opportunities to further the usefulness to the company of the strictly auditing functions.

The question of effective organization in these cases is, of course, to be determined primarily on the basis of the facts of the particular case, but with due regard for certain underlying principles, including:

(1) The adjunct function should not in any way interfere or conflict with the primary function of auditing. For example, a systems and methods division that was primarily a service group to help carry out systems and methods changes where the decision regarding the change rested with a committee or another department, might not be considered to impair the auditing department's independence in the review of the company's procedure. The contrary view might be held where the auditing department, through its systems and methods division, was directly responsible for the prescribed systems and methods.

(2) The adjunct function should be recognized as such and, to the extent feasible, handled by separate employee groups in the department.

(3) The benefit to the company in having the adjunct function handled by the auditing department should be periodically reviewed in the

light of current conditions. For example, the special qualifications of the auditing department for handling the function may no longer be apparent, or the abilities and time originally available for the function may now be inadequate.

To return to auditing fundamentals, the internal auditor's report—the final scene in the play—requires, from the standpoint of organization, little comment that has not already been covered inferentially in discussing reporting responsibility and the importance of adequate provision for the staff function in the audit department organization. Brief consideration of two unusual methods of follow-up on audit findings will be of interest as thought-provoking, even though not generally considered applicable to the usual situation.

The usual methods for trying to assure both appropriate attention and action on the audit results and the recommendations include, of course, the preparation of suitable reports with copies for responsible and interested executives. Emphasis is sometimes given by bringing matters of special importance to the attention of management at the higher levels.

A large financial institution has the following procedure: copies of all audit reports, containing exceptions and comments on matters in the branch or department audited, are placed before the organization's operating committee. This is a committee of key executives with responsibility second only to the president and the board of directors. At the meeting at which the operating committee considers the audit report, it considers the reply or the comment of the branch or department manager. An abstract of the comments in the audit report, the reply, and the recommended disposition of the matter are included in the minutes of the meeting. Moreover, if the committee is dissatisfied with the conditions found, its secretary is instructed to transmit this feeling to the department manager. The minutes of the committee do not become official until the president has read and initialed them.

An oil company, with an audit staff covering all states east of the Rockies, makes a regular practice of holding a conference, for possibly a full day, in the main office of the marketing area under audit. The conference is attended by the audit department manager, or assistant manager, the corresponding representatives of the home-office accounting, marketing and operating departments, and by the responsible marketing area field executives. The audit report is a summary of the matters discussed at the audit conference. The audit has usually been in progress about two months with an assigned crew of three men, and some of the matters discussed and decided at the audit conference have been the subject of interim memoranda, prepared and distributed during the course of the examination.

In concluding my remarks, although the topic is not in direct point with my subject, I would be derelict in my duty as a representative of The Institute of Internal Auditors were I not to bring to the attention of this forum the keen interest of The Institute in cooperating with educational institutions. Almost from organization, not yet five years ago, committees have been reviewing or preparing courses in internal auditing, and with chapters now in nearly all sections of this country and two in Canada, we are in a position to extend our cooperative efforts. In fact several chapters have already been responsible for giving lecture courses in internal auditing at university schools of business. The Educational Committee of the national organization has undertaken this year to start an active program of cooperation with the American Accounting Association. One of the Institute's organizers, the author of the first comprehensive volume on internal auditing,* a publication which gave tremendous impetus to growing interest in the subject, Dr. Victor Z. Brink, has now returned to Columbia University from service with the Army Headquarters Staff. He has recently been appointed to give a full-time course in internal auditing in the School of Business of that institution.

This emphasis on educational activities in The Institute's national and local organizations derives from the thought that interest in the education of its future members is one of the prerequisites for a well-established, professional status, and from the realization that in the long run the solution to the problem of the availability of capable, internal-audit staff men rests with the colleges and universities. Moreover, in order to get and keep qualified manpower, the profession of internal auditing must be made to interest young men in their formative years.

And may I say also that cooperative effort in the educational field is only one of a number of activities that The Institute of Internal Auditors has undertaken and is carrying on. Forums are held throughout the country for discussion of new techniques and new approaches to enable internal auditors to learn of developments in their rapidly broadening field. The publication of books and a periodical is serving a similar purpose. Through joint participation in this organization, internal auditors have a means, beyond their individual powers, for bringing about a general realization of the important uses some businesses are making of modern internal auditing, and of the still untapped possibilities awaiting development.

* Brink, Victor G., *Internal Auditing, Its Nature and Function and Methods of Procedure;* New York, The Ronald Press Company, 1941.

Perhaps there is some merit in this thought: a world almost persuaded to give up a considerable measure of national independence, in return for a system of collective security—relying on control of atomic energy and armaments through independent audit and inspection of each nation's mines, supplies and facilities—will not fail to note the importance to a business organization of a means for control which relies on the audit, inspection, and reporting of a specially trained unit, independent of the several operating departments of the business. In any event the already wide acceptance of this viewpoint provides a real start toward "Organization for Effective Auditing."

ORGANIZATION FOR EFFECTIVE PROFIT CONTROL

By D. M. Sheehan
Comptroller, The Monsante Chemical Company, St. Louis, Missouri
Vice President, The Controllers Institute of America

As we begin our discussion of this subject let us first define what is meant by "Organization for Effective Profit Control." As I visualize it, this means an organization so constituted and operations so planned that effective control can be exercised over all activities of the company to the end that the maximum of profits will be attained for the capital invested.

The activities of every individual connected with an enterprise have their effect, in one way or another, on the profit results since the results of all activities are, in the final analysis, reflected in dollars and cents in the profit and loss statement. Accounting comes into the picture in measuring the effectiveness of the individuals and the activities of the enterprise.

No amount of accounting control, however, can be effective unless there is proper organization throughout the entire company. In my opinion, proper organization comprehends the placing of the responsibility for certain definite accomplishments on various individuals, with a clear line of demarcation between the duties and the responsibilities of each individual. Needless to say, with this responsibility should go the authority to discharge the duties assigned. All of these activities must be coordinated to insure a smooth-working organization.

The type of organization depends to a great extent upon the size and kind of business. There are, however, certain fundamental divisions which are more or less basic with every enterprise. These fundamental divisions are sales, production, research, finance, and accounting.

Each of these broad divisions should be headed by a man charged with the responsibility of seeing that all the activities of his particular field contribute to the success of the enterprise. Over all of these, of course, should be the executive management consisting of the president or executive committee, as the case might be, whose duty it should be to establish broad, general policies for the company; to approve the over-all plans of the enterprise, and to coordinate the activities of the various divisions of the company to insure that the policies are successfully carried out and the planned results attained.

The executive management is responsible to the Board of Directors which has the primary responsibility to the owners to see that the operations of the business provide a reasonable return on the capital invested.

The executive in charge of sales has the responsibility for selling the products of the company at prices which will yield the desired profit. The person in charge of production has the responsibility for manufacturing, at the lowest possible cost, the products which are to be sold. The research director is charged with the responsibility for developing new products and processes, and for improving present products. The chief financial officer has custody of cash and securities, and other financial duties. The chief accounting officer is responsible for all accounting matters of the company. Upon this executive falls the major portion of the task of administering the plan for effective control through accounting. This constitutes one of his most valuable contributions to management.

The first responsibility of the chief accounting officer, or let us call him the comptroller, is to have an adequate, intelligent organization and a good accounting system. This is fundamental. While there are various ways of organizing an accounting department, one effective way is to organize it along functional lines; by this I mean a general accounting section, a cost accounting section, a property accounting section, a budget section, an internal auditing section, and so on, with a qualified person in charge of each section. Here again the element of responsibility enters into the organization in that each department head is responsible for the proper functioning of his particular section. Whether these functions should be centralized in one location depends to a large extent on the size of the company and how widespread its operations may be. Personally, I am a proponent of centralized accounting; my experience has been that it provides better control for management. To insure the success of any plan for effective control, the comptroller must have the cooperation and wholehearted support of the executive management.

A system of effective control involves the forecasting and planning of all the activities of the business in such a way that the capital invested, the maximum return on such capital, the sales volume, the production, and other costs are all brought into proper relationship. When the plan is formulated a means must be devised to insure attainment or realization of the plan. This "means" we call budgetary control, which is the tool by which the comptroller provides management with information showing how closely the actualy results compare with the original plan.

In other words, through forecasting and budgetary control, the management is able to inform each responsible individual what it expects of him in his particular activity and to determine at a later date how he is performing. If he is failing to meet expectations, the management can promptly determine the reason and take the necessary steps to correct the situation. The formation of a plan requires careful forethought and the joint cooperation with the comptroller of the entire management group of the company. The burden of the work naturally falls to the accounting department in preparing and furnishing the necessary forecasts and accounting information, which are the backbone of this plan.

The forecast of sales is the most important element of the plan because sales represent the source from which the income of the company is derived. The forecast of all the other activities of the company must be made in relation to the sales forecast. For instance, the amount to be expended on new facilities depends upon the demand for the products to be manufactured. If the sales demand exceeds the production capacity of the plant and expended facilities are required which will cost in excess of the available capital, additional financing is indicated. The plan of production must be related to the estimated sales. The expenses of all departments must be paid out of the revenue derived from sales and, consequently, the budgets for these departments must be restricted to an amount which will leave as profit enough of the sales dollar to yield the required or planned return on the capital invested in the business.

A great many factors enter into the consideration of the sales forecast, such as market analyses, general business trends, conditions within the industry, trend of prices, competition, prospective requirements of large customers, and the productive capacity of the plant. Past performance, while not in itself a basis for an accurate forecast, furnishes a dependable guide along with the other factors mentioned. The over-all sales forecast is a composite of the forecasts of each territory or zone, which in turn is made up of the estimate of sales for each individual salesman.

When the sales forecast has been completed and agreed upon by the executive in charge of sales, it becomes a measuring stick or gauge by which the results of the selling activities can be measured and controlled. For example, if the sales of any particular product do not measure up to the forecast or planned sales, the sales manager must explain this difference. He, in turn, has passed on responsibility to assistant sales managers and others, down to the individual salesmen for the sale of products in certain territories, for the sale of particular products, and so on. In this way it can readily be determined where and why the sales have not come up to expectations. It is, of course, of no value to have this information unless some action is taken; therefore, it is incumbent upon the responsible person to devise ways and means to institute corrective measures, so that his part in the over-all plan is adhered to.

Further, a review of the actual sales will indicate whether the forecasted sales prices are being obtained and, if they are not, reasons must be advanced by the responsible parties. All this information must be brought to the attention of the management by the comptroller through informative and constructive reports.

After the sales forecast, the next important item is the determination of the production plan or forecast. Having determined the price at which the products may be sold, it is essential that the production costs of these items be such that the gross profit will be sufficient to absorb the other costs of the business and leave the required net profit. The executive in charge of production, who has the primary and over-all responsibility, delegates certain responsibilities to a plant manager who, in turn, departmentalizes his plant to the extent needed to effectively control the various operations. This can be done by dividing the plant into cost centers. These cost centers are usually comprised of production departments as well as the various service departments of the plant.

A budget, which embraces all the elements of cost within the section, is prepared for each service department in the plant. It is then the responsibility of the department head to either operate within his budget or be prepared to explain why he has been unable to do so, and be ready to suggest corrective measures.

Standard or budgeted costs are established for all products. There are various types of cost standards and it is not my intention at this time to enter into a discussion of the different types. Regardless of the type of standards used, the primary purpose is the planning of production costs in order to have a gauge by which the actual cost can be measured. Adequate cost reports must be prepared by the accounting department to show the responsible persons wherein the actual results fail to meet the planned objective.

It frequently happens that because of the sales department's failure to meet its forecasted sales, certain departments or plants do not operate at the planned capacity; and hence, through no fault of the production or plant manager, the standard or budgeted costs are not attained. Through the use of standards computed at various levels of production, the portion of the variances between planned standards and actual costs, due to the inefficiencies of the production department and the portion due to failure of the sales department to sell the forecasted volume, can be ascertained. For example, if the sales forecast comprehends plant operation at full capacity, the standard cost at the capacity level can be established. Standards can also be established at various lower levels of production. If a department does not operate at full capacity, the actual results can be compared with the standard cost at the actual level of production; the variance between the actual cost attained and this standard represents the inefficiency of the production department. The difference between the capacity standard and the standard for the actual level of production represents the loss which is due to the sales department's failure to meet its quota.

In addition to the responsibility for the sales of the company, the executive in charge of sales has the responsibility for keeping his selling expenses as low as possible while yet attaining the forecasted sales. He, therefore, delegates responsibility to assistant sales managers in charge of certain territories and branch offices. All of these individuals should have budgets of selling expenses planned with the idea that each person is responsible for the expenses incurred by him and by those under his supervision. The accounting records should be so arranged that the actual expenses are accumulated for each selling group in the same manner that they are budgeted. Periodic reports should be made to the sales manager showing the actual expenses incurred as compared with those budgeted. He should use these reports in controlling the expenses for which he is accountable.

The research activities of the company can also be controlled through the use of budgets. After the executive management has established the amount which can be spent on research—dependent to a great extent on the forecasted sales—the research director, with approval of the management, can forecast or budget the amount to be spent on individual research projects. The actual expense can be compared with the budgeted amount and the research director can be held accountable for any expenditures in excess of those allowed him.

Other departments, under the financial and administrative categories, necessary in an organization are the accounting, the legal, the purchasing, the executive administration, and so on. The organization should be so constituted that the individuals responsible for the several functions of such departments are charged with the expenses incurred by them in the performance of their particular assignments. The budgeted expenses for these departments can also be determined and the directors of such departments held to strict accountability for adhering to their budget allowances.

A forecast or plan does not of itself insure profitable operations, neither do the reports issued by the comptroller showing the comparison of the actual results with the forecast, unless these reports are used by the management as a basis for action.

If the plan is intelligently and carefully prepared and closely followed by the management, it can be a means of insuring a successful enterprise. To illustrate, let us assume that a complete forecast has been prepared and that the estimated profit for the ensuing year does not show an adequate return on the money invested. It is necessary to study and analyze all of the factors entering into the forecast to see what can be done to increase the profit to the desired amount. The sales forecast can be reviewed to see whether it is possible to increase the revenue of the company. All costs, including manufacturing costs and the various expenses, must be reviewed with the persons responsible for the various departments and the expenses must be pared down to the desired level. In other words, the management can plan its operations in such a way that economies can be instituted and costs and expenses limited to an amount which will insure that the proper return is obtained. It is far better to do this in advance than to wait until the end of the period and then find that the profits are not sufficient to pay a reasonable return to investors.

I have mentioned at various times factor of return on the investment in the business. I have had in mind the over-all return to the owners of the business on the total capital they have invested. In order to control this over-all return, however, it is important that the management of a company keep this factor in mind when considering how to invest the funds of the business, so that the final result of the expenditure will show an adequate return on the investment. It is possible that it may be desirable, or even necessary, to invest funds which in themselves will not directly return an adequate profit, but which will assist in some other way to the end that the business as a whole will be adequately rewarded.

In the case of a company engaged in manufacturing, the basic item to be considered is the investment to be made in plant and manufacturing facilities. This investment must bring, through the sale of the manufactured goods, a proper return on the amount invested.

When I speak of this return on the investment in a particular project, I am referring to the realized net income after the deduction of all charges —selling, administrative, research, income taxes, etc.—and to the relationship of this amount to the funds invested. The investment includes not only the amount to be expended for the plant but also, in the case of a plant extension for the production of goods, a proportionate amount for service facilities used by the plant and an adequate sum for working capital.

In order that we may have a clear understanding of my conception of the computation of the return on investment in a manufacturing plant, let us assume that:

The contemplated plant extension will cost......	$100,000.00
This will result in additional service facilities (required either now or later) of..............	40,000.00
And will require additional working capital of....	30,000.00
A total required investment of................	$170,000.00

After consideration of the sales to be obtained from this new plant extension; the cost of production, administration and selling; the research expenses applicable to this plant; and all other items including income taxes, the annual estimated realizable profit has been carefully computed to be $34,000, or an annual return of 20 per cent on the investment of $170,000.

In an industry such as the chemical industry with its well-integrated manufacture, the previous investment in a product to be used in the manufacture of the product for which the investment is made should also be considered in the determination of the total required investment for the latter product.

The comptroller should assiduously check to be certain that the additional estimated amounts, used in the calculation of the required investment, are reasonably accurate and the profits realized from the investment are as planned.

One of the most pertinent ratios which can be developed is the percentage relationship of the total net income of a company to the total investment in the company, represented by its capital stock and surplus. If a company is capable of maintaining this ratio at a proper level, it need have no fear of having to close its doors for lack of adequate profit.

By reason of greatly increased income taxes and mounting costs as a result of the war, it has been difficult for companies to realize a satisfactory return during the past several years, but I am confident that eventually business can again be operated so that a desirable return on investment will be possible of attainment.

In my opinion, if a company, large or small, manufacturing a product for which there is adequate present or potential demand, has a plan for operation which comprehends the forecasting of its cash position, its earnings, its required additional investment in plant facilities and other items; and if it has at hand the means of controlling these factors—principally by good accounting and the measurement of investment of funds on the basis of profit return on such investments—there is every reason to believe it will be successful. Such a company has an organization which can effectively control its profits.

SECOND SESSION

Friday, May 17, 1946—1:00 p. m.

Luncheon

Faculty Club

THIRD SESSION

FRIDAY, MAY 17, 1946—2:30 P. M.

Commerce Auditorium

Chairman:

WILLIAM F. MARSH, C.P.A., *Lybrand, Ross Brothers and Montgomery, Pittsburgh, Pennsylvania*

Address: "A Sound Tax Program and Its Relationship to the Continuance of Free Enterprise"

THOMAS TARLEAU, *Partner, Willkie, Owen, Otis, Farr and Gallagher, New York; Member of the Committee on Postwar Tax Policy*

MARK E. RICHARDSON, C.P.A., *Partner, Lybrand, Ross Brothers and Montgomery, New York; Member of the Committee on Taxation, American Institute of Accountants*

A SOUND TAX PROGRAM AND ITS RELATIONSHIP TO THE CONTINUANCE OF FREE ENTERPRISE

By THOMAS N. TARLEAU

Partner, Willkie, Owen, Otis, Farr and Gallagher, New York, New York
Member of the Committee on Postwar Tax Policy

The continuance of the free enterprise system, in my opinion, depends upon its ability to maintain a prosperous economy, an economy in which production, employment and consumption are at a high level. The prolonged experience with large-scale unemployment during the 1930's and the widespread misery and human waste entailed by it has not been forgotten by the American people. A free enterprise system must satisfy the profound desire of our people expressed in the phrase "jobs for all who are willing to work."

Under a system of free enterprise, work opportunities are only in small part provided for by public agencies. Necessarily, Government must employ enough persons to assure the efficient performance of public services, but in the main where the tools of production are privately owned, private enterprise must supply the largest part of employment opportunities. If private enterprise fails to do so, inevitably there is a cry for Government to step in and provide jobs. It will be fruitless for those who believe in free enterprise to argue against Government intervention in private business if private business is not able to meet the problem of postwar employment. I am convinced that no Government can survive that does not step into the breach if private enterprise fails to accomplish what the people expect of it. On the other hand, it is not enough to seek to impose upon private employers the responsibility to provide employment for all who are able and willing to work. It is also necessary to recognize the motives and the incentives that must operate under a free enterprise system. The mainspring of the free enterprise system is the profit motive. The Government fiscal policy should be drawn with an intelligent and sympathetic understanding and a clear recognition of this fact. Fundamentally, that means that those who gain profits as a result of successful risk-taking, must be allowed to retain enough of what was gained to provide for adequate inducement for continued effort on their part and to encourage others to venture their capital. In other words, the Government has a definite responsibility to adopt and apply such policies of taxation, regulation and administrative control as will not weaken the environment in which citizens can and will engage vigorously in economic effort.

In the fall of last year a committee, acting under a grant established by the Falk Foundation of Pittsburgh to study postwar tax policy, issued a report entitled "A Tax Program for a Solvent America." I had the pleasure of serving as a member of that committee and naturally I am impressed with its approach to the problem of a sound tax program. In framing a tax program various considerations may, of course, be predominant. Obviously, the reason for any taxation measure is to raise revenue. In the raising of revenue, however, other motives must be taken into account which will largely determine the form and scope of the taxes to be imposed. If, as an instrument of fiscal policy, a revenue measure is not only to raise the revenue but is intended to aid in reducing inequalities of wealth and income, a great deal of stress would be laid on steep progression in the rates of estate, gift and individual income taxes. High exemptions would be provided and the upper surtax brackets would be very heavily taxed. On the other hand, if the tax bill is drawn with the thought that revenue must be raised in such a way that the impact of the taxes should not impede, more than absolutely necessary, the free enterprise system, then recognition must be given to the fact that essential to the operation of such a system are inequalities of income. The Committee on Postwar Tax Policy has made its suggestion in the light of the second of the two theories above mentioned. Much can be said for each theory. The Committee's position, however, is one which is directly related to the continuance of free enterprise.

Another problem which must be explored in order to determine a sound tax problem is that of the federal budget policy. There has recently come into considerable favor the thought that an annual budget balance is not only unnecessary but undesirable, and that a cyclical balancing of the federal budget is what should be sought for. This view accepts the economic cycle as inevitable and proposes deficits for depression years to be offset by revenue surpluses in prosperous years. The Committee on Postwar Tax Policy has taken the more unpopular position, namely, that in general current revenue should be sufficient to cover expenditures. It is true that such a condition may not be exactly produced every year. In practice there will always be some unforeseen variations of tax yield. Such variations should not disturb us. The variation, however, should be nominal, and it is the policy recommended by the Committee that a normally balanced budget, as indicative of a fiscal stability, will be more beneficial for the private economy and more conducive to the long-run stimulus of private effort than a policy of deficits.

It should again be emphasized that our concern is with the maintenance of production, employment and consumption through private enterprise. It is possible, of course, to create purchasing power through income payments made from Government deficits. In our opinion such a program not only would result in a steady increase of the public debt, with the possibility of a serious effect on the stability of the currency, but in essence would lack the energizing quality so essential to sustain prosperity. Necessarily, no policy of budget balancing has the slightest possibility of success unless federal expenditures are kept at such a level that, without crippling the economy, taxes can be raised to defray costs of Government. The expenses of Government can be generally, if loosely, defined as obligatory expenses and optional expenses. Among the obligatory expenses are the maintenance of an adequate defense establishment, and the maintenance of the essential functions of the federal government, such as the Post Office, and other items of federal civil administration. A federal budget limited to these obligatory services would not be a difficult one to balance with a reasonable tax system. As the amount of the optional expenses increases, the difficulty of balancing the budget necessarily becomes greater, and the temptation to resort to deficits becomes stronger. The relationship between the budget and a sound tax program cannot, therefore, be over-emphasized.

In devising a tax program to fit with the philosophy of a balanced budget, the question of revenue stability becomes important. A balanced budget means that we must also have a stable tax system—a system which may be depended upon to produce a substantial and comparatively steady flow of revenue under varying business and economic conditions. If such a stable tax system is to be achieved, necessarily there will have to be a diversity in the methods of taxation. There will have to be a reliance upon various forms and methods of taxation rather than seeking revenue from only a single tax source. Economic analysis reveals that business profits, for example, tend to expand more rapidly than national income when the national income is rising, and to decline more rapidly when national income is falling. Hence, although business profits must of necessity be an important element in the tax base, it is obvious that they become a dwindling source of revenue during a period of recession. Another example of a tax which is subject to cyclical fluctuations is the capital gains tax, where the revenue yield depends upon a rising market. It does not follow that where national income declines, tax-paying capacity similarly disappears, and though the yield from the income tax and capital gains tax may be diminished, the yield from excise taxes will not necessarily go down comparatively. Consumption habits are relatively constant and taxes which are based to some degree on spending are less irregular in yield than those based entirely on the amount of income received. Moreover, in considering revenue stability, there is a further advantage which should not be overlooked. Under a stable tax system, it should be possible for taxpayers to plan their affairs with more assurance than they have today of freedom from disconcertting changes in the law or the rate of tax. This is a problem again, however, the solution of which will largely depend on the level at which federal spending is established.

The Committee on Postwar Tax Policy, in its recommendation of a sound tax program, has recognized that the income tax, individual and corporate, will have to provide a substantial part of the federal revenues during the postwar period, although there should be a diversity of revenue sources to assist in assuring the stability of receipts, which, as I have previously indicated, is the best protection against further borrowing.

With respect to the individual income tax, the Committee recognized that it is particularly important that attention be given to maintaining a balance beween revenue need and the effect of the tax on individual incentives. For this reason, the Committee recommends that individual surtaxes should be lowered from the present abnormally high wartime levels. The extent to which the surtax scale can be revised, both as to its maximum levels and the rates of progression, depends, of course, on the size of the postwar budget. In this connection, the Committee has felt that it would be a helpful step towards simplification if a single scale of graduated rates were provided which would replace the present combination of normal and surtax rates. The initial rate of this scale should fall between 15 and 20 per cent, according to revenue needs, and would rise to 40 to 45 per cent on the $25,000 to $50,000 bracket; 40 to 54 per cent on the $100,000 to $200,000 bracket; and 67 to 72 per cent on one million dollars and over.

The question of the size of the personal exemptions and credits for dependents, depends again upon the postwar budget. In view of the budget suggested in various quarters for a normal postwar year, the Committee has recommended the continuance of the personal exemption of $500 for the taxpayer and for each dependent. Any lower exemptions would bring in large numbers of additional taxpayers but they would contribute only a thin slice of tax revenues, while the large part of the revenue from such lower exemptions would come from those already in the income tax system. On the other hand, the increase of the exemption would have two effects, both undesirable. In the first place, it would create a need for higher taxes from the middle and upper brackets where the taxes are already too high from an incentive standpoint; and, in the second place, the shifting of further taxes to the upper and middle brackets would decrease the stability of the revenue system, since the incomes of the lower brackets tend to be much more stable than those that are high in the surtax scale.

One of the striking innovations in tax administration during the last five years, has been the introduction of the system of withholding and payment of taxes currently. Undoubtedly, particularly at the start, the introduction of the requirements of withholding has created difficulties for employers. However, it can hardly be denied that today withholding and paying-as-you-go has proven its usefulness, and if the personal exemptions and credit for dependents are to remain at a fairly low level, retention of this principle of current payment is essential.

The Committee, in considering taxation of personal incomes, made an extensive investigation of the problem of the joint return. The family income concept has made considerable headway recently as a method of imposing the personal income tax. The issue of mandatory joint returns was made in Congress and resolved by an adverse vote. The Committee has felt that the compulsory joint return results, in some measure, in the determination of the tax on one income by reference to the income of another; and, to that extent, there is an essential injustice in the proposal.

Another item, of considerable importance in the individual income tax, that received the consideration of the Committee is the taxation of capital gains. There is no part of the Internal Revenue Code which has been more amended than the capital gains and losses provisions. There seems to be no formula for the treatment of capital gains and losses that has proven satisfactory. There are those, of course, who contend that no capital gains should be taxed and no capital losses should be allowed; and there are others who are equally convinced that capital gains should be taxed in full and losses allowed in full. It would carry me far beyond the bounds of this paper if I attempted to analyze the merits of the different proposals made with respect to the treatment of capital gains and losses. The Committee on Postwar Tax Policy could find no proposal, acceptable to its members, which it was willing to recommend as preferable to the present treatment accorded by the Internal Revenue Code. One of the justifiable criticisms of tax administration has been the frequent tinkering with the capital gains sections, and the consequent uncertainty on the part of taxpayers of what tax they may have to pay if a capital investment should prove successful. The existing capital gains-and-loss provision represent the result of an extensive consideration of the problem by the Congress in 1942, and represents a compromise of conflicting views. Like all compromises, it is not entirely satisfactory. For example, provisions have been criticized on the ground that they do not permit complete allowance of capital losses against ordinary income. On the other hand, it has also been urged that the six-month period is too short to serve as a rational distinction between long-term and short-term gains and losses. These criticisms may be justified. However, unless some striking improvement can be made by a revision of these provisions, it seemed to the Committee best to continue the present system for a period of at least five years.

The relationship between individual income taxes and the corporation tax is one which has come to the fore recently in any discussion of tax reform. The Committee on Postwar Tax Policy strongly approves the suggestion, that has come from many sources, that the income upon which corporations are taxed should not again be taxed to the individuals receiving it as dividends, except to the extent that the individuals may be subject to tax rates higher than those paid by the corporation.

This double taxation might be corrected by any of a number of devices. One school of thought would relieve taxpayers entirely from income tax on their dividends considering that such income was sufficiently covered by whatever system of taxation was put upon corporations as such. There are obvious difficulties here, the chief one being the abandonment of the principle of progression in the taxation of individuals so far as dividends are concerned. The Committee considered the complete exemption of stockholders as to dividend income, both unsound in principle and lacking in any real popular support. On the other extreme, it has been urged that corporations should be exempt from taxation upon their profits and should postpone any tax at all until the inclusion of the dividends in the taxable income of the stockholders. This device, however, runs into its own difficulties. The principal one, of course, is that of undistributed portion of corporate earnings. If the total income of corporations were currently distributed in dividends to stockholders, the total exemption of corporations from income tax might be the answer to our problem. Obviously, however, a certain amount of the earnings are retained. Therefore, under this suggestion, a large segment of the national income would escape current taxation. The Committee believed this to be fundamentally unsound and did not consider that it was a sufficient answer that at some future time all corporation earnings are destined to go to stockholders. Furthermore, this arrangement would involve gross favoritism of corporations as against unincorporated business, all of whose net income is taxable whether retained or not. Perhaps more important in some respects than the other objections is that the taxation of corporations has become firmly imbedded in the American tax structure, and its proposed amendment would utterly fail of popular support.

The medium position between the two extremes is that the corporations should be taxed upon their income, but that in taxing the dividends to stockholders some account should be taken of the tax previously paid by the corporation. The problem, therefore, is to find an adjustment of the individual and corporate income taxes which will avoid undesirable double taxation.

There are four principal methods whereby this double taxation could be eliminated. One is to permit the corporation to deduct dividends, as it now deducts bond interest, in arriving at corporate taxable income. The corporation, however, would be subject to tax only on its retained income. This arrangement seems simple and its logic is clear. It suffers, however, from all of the defects of any undistributed profits tax, because this is in essence what the tax on retained earnings is. A tax on the retained earnings would have to be very high in order to prevent tax avoidance. The problem of the new and growing corporation as against the well-established concern, the problem of the debt-ridden corporation, and all the other difficulties experienced in the administration of the undistributed profits tax, provided for in the Revenue Act of 1936, would have to be solved. It is doubtful whether in the near future Congress would be willing to return to the undistributed profits tax.

A second method starts with the theory that under strict logic shareholders should report as part of their taxable income their pro rata share of the total incomes of the corporations in which they have invested, regardless of whether such incomes are distributed or not. The tax paid by the corporation would then be considered merely an advance on account of the stockholders' tax.

In our opinion, this device is open to two serious objections: In the first place, it would be an administrative nightmare in all instances where corporations with large numbers of stockholders are involved. In the second place, in most instances, in corporations with widespread ownership, it is unreal to believe that the undistributed income really measures income of the individual stockholders. It is true that they have an equitable interest in their pro rata share of the undistributed earnings but, until actual distribution, the degree of economic benefit that the stockholder realizes is difficult to measure and can hardly be stated to be a fair subject of taxation.

A third method is to regard corporation taxes as paid on behalf of the stockholders and withheld from them but only with respect to that part of the corporation's net income which is distributed in dividends. If, for example, a corporation was subject to a 20 per cent tax, it would be assumed that all its dividend payments were actually 20 per cent less than they would have been in the absence of any income tax payable by the corporation. If a stockholder received a $400 dividend it would be presumed that, except for the corporation income tax, his dividend would have been $500. Under this method the stockholder would be required to add to his total income the $500 and not the $400 actually received. After computing his individual tax he would take as a credit the $100 tax paid by the corporation.

This is essentially the British method. The only criticism of this method is its cumbersomeness in administration. It would also involve some policy decisions, for example, whether, where an individual's total tax turned out to be less than the tax withheld on account of his dividends, there should be refunds. The British permit of these refunds. With a broad tax base, the volume of refunds might be extremely large. There is also the problem of whether a refund should be given to tax-exempt institutions, on account of the tax a corporation paid on dividends received by it.

The fourth method, which is recommended by the Committee, is to allow the individual a credit to offset in his own tax, on account of the tax paid by the corporation with respect to his dividends. Prior to 1936 this method was applied to some degree by excluding dividends from the individual normal tax. To the extent that the corporation tax rate exceeded the individual normal tax rate, the device failed to achieve complete elimination of double taxation, and it obviously made no correction at all with respect to surtax. Under the single tax rate recommended by the Committee, the procedure would be as follows: the stockholder would, of course, include his dividends in his taxable income. After computing his tax he would take a credit, on account of the tax paid by the corporation with respect to his dividends. This credit would be calculated by multiplying his dividends by the lowest bracket-rate of the individual income tax. In order to avoid refunds it might be provided that the credit should in no case be greater than the total tax due. This method is recommended principally because of its administrative simplicity. It does not make a perfect adjustment between the corporation and individual income taxes. It does, however, produce substantial equity and should be simple in operation.

With respect to corporate taxes, the Committee has several suggestions to make. In the first place, it believes that the present source of corporate taxes should be abolished and a single tax on income should be levied. In order to achieve a better integration of the corporate tax and the individual income tax, it will be desirable to have the tax on corporations at the same rate as the initial rate of tax on individual incomes.

The Committee has recommended the repeal of the present tax on intercorporate dividends. It will be recalled that under existing law 15 per cent of any intercorporate dividends are, in effect, included in taxable income. This results in a tax on intercorporate dividends of something less than 6 per cent. The intercorporate dividend tax dates from the inception of the drive made against unnecessary holding companies. It was intended to penalize corporations in which the holding company set-up was used. To a very large extent the holding company problem has been solved. Any corporate dividend tax, therefore, has really no purpose except to burden corporate earnings with an additional tax so small as not to be a substantial revenue raiser, and it adds to the complexity and inequity of the tax system.

Another suggestion of the Committee is that the 2 per cent differential tax on corporations making consolidated returns should be eliminated. The necessity of allowing the use of consolidated returns in order to properly state the income of an affiliated group of corporations has always been recognized by the Treasury. The practical elimination of the use of consolidated returns in the early '30's, was made over the vigorous dissent of the Treasury. Its restoration had Treasury approval. If from the Government standpoint the use of this form of reporting income is sound, there seems to be no reason why the penalty tax should be imposed upon corporations for availing themselves of it.

One of the great problems in any system of income taxation is that of the period during which the income is to be determined. In this country income has been computed on the basis of an annual system of accounting. In case of taxpayers having fluctuating incomes, the use of an annual system for determining income may result in a very great inequity. Under existing law, through a system of carry-backs and carry-overs, averaging of income and losses over a five-year period may be obtained. The carry-back provision, which allow the losses of a given year to be carried back and applied against the income of the two previous years, was a useful instrument for handling certain types of wartime problems. It presents undesirable features, however, as a permanent addition to our income tax system. In the first place, it has led to charges that in some instances corporations have taken advantage of the privilege of carrying back losses to unnaturally sustain the losses, since the Government would have to refund taxes of the earlier years. Whether such charges are justified or not, I do not intend to discuss. The possibility of tax avoidance by use of carry-backs is present at least in quite a number of cases. In the second place, for a Government which should attempt to balance expenditures with receipts, the possibility of refunding part of the receipts because of future corporate losses makes budget balancing very difficult. The Committee, therefore, has recommended that in lieu of the present system of carry-backs and carry-overs, business net losses be allowed as a deduction against business profits by a carry forward over a period of at least five years.

Again, with reference to business income, not only is there a problem in averaging incomes, but there is also a gap between net income as defined by the statute and net income as determined by the accounting operations of the business for its own purposes. Some discrepancies between these two net incomes, net income for tax purposes and net income for general business purposes, is perhaps inevitable. We believe, however, that to some extent this situation needs correction by giving greater recognition, for the purposes of determining taxable net income, to the procedures and practices that are followed by business itself. There are three points, among others, on which the law and administrative practice should given greater recognition than at present to business accounting in the determination of business net income. The first of these is with respect to depreciation and obsolescence. There has been no part of a corporation's return which has created more difficulty than the allowance for depreciation. The Treasury seems to have a fixed tradition to hold allowance for depreciation to an irreducible minimum rather than, using the words of the statute, giving a "reasonable allowance for depreciation." The Committee believes that the rates and manner of accrual for depreciation purposes, within the reasonable limits of generally accepted accounting principles, be left in all cases to managerial judgment.

The second place, where the law in its practical application should be brought into closer agreement with business practice, is with respect to expenditures for intangibles of which research and development are the most important. A third point is with respect to salary determinations. The statute provides that in determining net income there shall be a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." Recently there has been a noticeable increase in those cases in which the Treasury questions the reasonableness of amounts of salaries paid by corporations. For many years the management's determination of the reasonableness of salaries was accepted, except in cases where the salaries were merely a subterfuge for the distribution of gifts or dividends. Today, even in cases where the salary is admittedly paid as compensation, Revenue Agents are frequently substituting their own judgment for that of the taxpayer corporation in determining the reasonableness of the compensation. Obviously, in the absence of any claim of fraud or duality of interest, those concerned with the internal affairs of the corporation and responsible for its results are in the best position to judge of the desirability and necessity of the amount of the salaries paid. The failure to follow the procedures and practices that are followed by business itself in these salary matters, leads to an unnecessary and dangerous variation between net income for business purposes and taxable net income.

In general, it is the Committee's feeling that an Internal Revenue Agent, in examining a corporation's return, should display much the same attitute that an independent auditor shows, namely, a general willingness to accept the judgment of management and accounting practices consistently followed, coupled with reasonable insistence upon accepted standards.

Excise Tax

From the general discussion at the beginning of this paper, it is evident that the Committee believes that there is a proper and useful place for excises in the modern tax system. The scope of such taxes could be narrow, wide or variable. The choice would depend upon revenue needs and upon how far it might be felt desirable to broaden the revenue base in the interest of avoiding extreme rates of income tax and of assuring revenue stability.

Excises provide a means of reaching that large part of the national income which, for one reason or another, is excluded from taxable income. Less than 36 per cent of the national income is subject to income tax. As recently as 1940, more than 82 per cent of income received by individuals was untouched by the personal income tax. In a tax system such as is proposed by the Committee, those liable for income tax would pay both income taxes and excise taxes. Those whose incomes are so small as to fall within the limits of the personal exemption and credit for dependents would pay excise taxes only. This would give effect to the generally accepted proposition that in a democracy all should make some contribution to the support of Government.

The most desirable excise tax is one which has a broad coverage and yet is easy of administration. The two classes of commodities most generally subjected to excise taxes are alcoholic beverages and tobacco products. At present there is an excise tax on gasoline. It is the Committee's opinion that this tax should be repealed and that gasoline should be left to the exclusive tax jurisdiction of the states. This tax is not important to the national government as a source of revenue; whereas, it is an essential part of the frame work of state finance and highway development.

Estate and Gift Taxes

The Committee's recommendation with respect to estate and gift taxes is perhaps one of the most debatable parts of its report. It recommends that the estate and gift taxes should be left to the exclusive jurisdiction of the states. Personally I feel that such a recommendation is unrealistic, and I think the further comments of the Committee report on estate and gift taxes are of greater utility. The Committee believes that, if the Federal Government is to continue the use of these taxes, the rate should be moderated, particularly in the upper brackets. It also feels that there is a definite need for a better coordination of the estate and gift taxes.

We are now in a transition period between wartime and peacetime finance. The problems of tax revision during this period are subject to a set of principles, the violation of which may have a serious effect upon the prosperity of the country. The following three principles should be observed as we prepare ourselves for the next revenue revision: in the first place, attention should be directed to the removal of the temporary taxes caused by the war, and to the making of those changes most likely to assure vigorous action by business during the reconversion period; secondly, changes should be made with the view to the long-range, postwar tax program, to avoid the necessity of further extensive revision as normal situations emerge; and, finally, the dollar-volume of tax reduction should not be as great proportionally at the dollar-volume of expenditure reduction, since some effort should be made to close the deficit gap as the transition period ends.

A SOUND TAX PROGRAM AND ITS RELATIONSHIP TO THE CONTINUANCE OF FREE ENTERPRISE

By Mark E. Richardson, C.P.A.

Partner, Lybrand, Ross Brothers, and Montgomery, New York, New York
Member of the Committee on Taxation, American Institute of Accountants

Introduction

It is somewhat exhilarating to take part in a program which has as its main theme the way of life known as "Free Enterprise." Indeed, it is a great pleasure to find a confidence so great that it speaks of "the continuance of free enterprise." While I have remained naive enough to believe that this nation would return to a system of free enterprise, I must admit that for some time the impression has been strong that we had wandered away on a road to some other goal.

Purposes of Sound Tax Program

Any misapprehension or misunderstanding as to the trail we have been following does not serve to confuse or confound the opinion, however, that we must have a sound, dependable tax program if we are to have real free enterprise. Such a program must have a two-directional purpose, and if it cannot achieve both, then it must find a reasonable balance between the two. Debt-financing of current expenditures must be stopped and we must provide sufficient revenue to meet our current needs, including some provision for debt retirement. At the same time, the tax burden must be so distributed as to be the least possible impediment to business and still be kept at as low a level as possible.

At first glance these joint purposes may seem to be as enigmatic as the impossibilities so ardently advocated by some politicians: increased costs without increased prices; higher wages to combat inflation caused by too much available purchasing power; more government control but reduced bureaucracy; etc. To the contrary, however, it does seem possible to achieve the above-stated purposes of a sound tax program. Such achievement depends upon the acceptance of one major change in tax policy and the taking of two certain steps toward the establishment of the change.

Sound Program Not Concerned Primarily With Rates

Before going into any detailed discussion of the suggested change in policy and the necessary steps thereunder, I would like to state a firm conviction that a sound tax program under free enterprise, as we consider that term in this country, is not primarily concerned with a rate or rates of tax or the form or nature of the tax. It is concerned, to a much greater degree, with the establishment of a system in which business has confidence, and one which is not subjected to continued change by a multiplicity of amendments. Business in general, large and small, will progress and expand much more readily with a 35 per cent tax rate that it is confident is necessary and well founded, than it will with a 20 per cent rate that is established solely upon a basis of political expediency. The successful, or prospectively successful, business man in the United States is not afraid of obstacles. He is willing to risk his capital and his efforts in an enterprise when he knows what the odds against him are liable to be. To him, that is what free enterprise really means. It may have some finely-drawn definition for the social economist or philosopher, but to the so-called "man-in-the-street" it means the right to sit in on a hand in the business game and play the cards as they are dealt, but with the knowledge that the "house" is honest and the cards not stacked.

For Revenue Raising Only

Fundamentally, therefore, free enterprise needs — indeed, cannot properly operate without — a tax system established for the sole purpose of raising the necessary revenue, and for no other. Social planning, wage controls, subsidies, etc., may or may not have a proper place in our national economy, even under a free-enterprise system. But conceding that they do, and that is quite a concession, they do not have a proper place in a tax system. I am very conscious of the arguments to the contrary, most of which resolve themselves into the ease of administrative controls by use of the tax laws. But I am not willing to concede that such an advantage offsets the loss of confidence and the instability engendered by an unsound tax program. Recently (New York *World-Telegram*, April 30, 1946) press publicity was given to an address by Leon Henderson before the New Council of American Business in Washington, in which he pointed out that one of the greatest concerns of businessmen today was the fact that the federal government was headed toward an 18 to 25 billion dollar budget. I find no faul with such a statement; the high federal budget is of major concern. Hower, Mr. Henderson proceeded to point out that taxation can now be used as a means of securing a better distribution of income and wealth, of directing the investment of government subsidies, of expanding social security, of stabilizing the dollar, of building more highways, and even of exercising moral controls by limiting the use of alcohol and tobacco.

It is true that these things can be done, but it is with the philosophy that accepts that they should be done as part of tax system that I take issue.

Necessary Policy Change

To reiterate: A sound tax program under a system of free enterprise should have as its sole purpose the raising of necessary revenues. This, then, is the policy-change which I consider fundamental: Stop the piece-meal, opportunist, social-effect amendments and revision of the Code and establish a fundamentally stable and consistent taxing status with rates varying as revenue needs vary; but, primarily, establish a system in which business has confidence.

Two Steps to Establish Confidence

How then can this confidence be established? What steps should be taken to convince business that the tax it pays is a proper, normal element of the cost of doing business; and not an improper, poorly determined levy, conceived in political bickering and delivered at a time, often prematurely, when it can gather the most votes? It is toward this general purpose that I would like to point the balance of my remarks.

As previously stated, two procedural steps seem necessary. Neither of the tseps would necessitate any statutory change. Both would necessitate a change in attitude and understanding at a high governmental level.

Integrated, Correlated System

The first of these would be the acceptance by the Congress of the fact that it is charged with the operation of the largest, most complex business in the world. It would have to come to the realization that certain fiscal policies have proven themselves sound for business and that others have shown themselves as destructive. There would have to be an understanding that a tax system, particularly the rates thereunder, should be established at the same time that the budget is reviewed and approved. There would then have to be a willingness to stick by that budget and by the corresponding tax revenue system. If we sincerely wish to know what is the major fault in our present tax system, let us consider the fact that there is practically no coordination between the functions of passing upon appropriations and passing upon the raising of revenues. The whole Congressional procedure, with reference to national finances, is unsound and would be ridiculously humorous if it were not so dismaying.

While appropriations are being considered, committee members, jointly and severally, are visited by a steady stream of bureau and department heads, social schemers, pressure groups, other legislators, etc.—all "loaded for bear" with a full line of arguments why this or that particular activity or enterprise should have more federal funds expended upon it. Any effort to reduce the appropriation for any item in the budget is met with "weeping and wailing and gnashing of teeth" by the day and by the volume. Depending upon how important the advocates are and how impressive their tales of woe; depending upon what dicker Mr. A from State B can make with Mr. Y from State Z for the benefit of their particular constituents—not the good of the nation as a whole; depending upon what particular group or geographical section of the country needs to be cultivated for the next election; depending upon other factors; but never depending upon the basis of what aggregate of funds will be available, are the appropriations made.

At some other time and before some other committee, you may—if you can stand the strain—watch the tax law being written. Here you will see the conscientious congressman driven almost to hair-pulling by an entirely different group of pressure-artists. There will be the customary arguments presented why each and every segment of the population, why each and every industry, why individuals, and why corporations, should all have their taxes reduced, and why none of them could possibly continue carrying their present burden.

By the time all of these have had their day, the congressional committee, balancing one argument against another, but never with its collective ear far from the ground where it can hear the political rumbling, finally drafts a tax bill. When the committee report is written, it might appear that some attention had been paid to actual revenue needs. As a practical matter, however, the bickering and balancing of interests will have caused a bill to be written which has truly lost sight of such actual revenue requirements. I ask those of you who have your own businesses and those of you who are responsible to any degree for the fiscal policy of someone else's business—could you function under such a procedure?

Whatever our tax program is to be, it must be a part of an integrated and correlated whole. The knowledge that tax rates would be set at a level necessary to raise the funds needed to meet a reasoned, advised budget, and not upon a basis of what the traffic would bear, would go a long way toward the restoration of confidence on the part of business and, therefore, to the continuance of a free enterprise system.

The first step, which I have just suggested, is not really a change in the tax system, as such. It is, of course, a change in the fiscal planning system which would provide for the integration therein of the actual tax system. The second step which I would like to propose is a change in system and it is more fundamental and would be more beneficial than the first.

This second step, as was stated previously, would require little or no statutory change. It would require, however, a complete change of heart and a complete change of philosophy in the Bureau of Internal Revenue from the Commissioner on down.

Change in Administrative Viewpoint

I would like to suggest that the Bureau of Internal Revenue abandon its present concept of its duty as that of extracting from every source the last possible penny obtainable under the law, and accept as its duty the administration of a complicated, confusing, indefinite tax statute on as reasonable a basis as possible.

I would like to suggest that our tax administrators, not just at the top but throughout the whole organization, be taught that they are not the representatives of a feudal lord or a dictator, but the representatives of all of the taxpaying public and that their principal duty is the ascertainment of the tax liability of each member of the group with as little conflict and disruption of business as possible.

I would like to suggest that the whole legalistic approach to tax administration be abandoned to as great an extent as possible. This suggestion is offered to taxpayers' representatives as well as to the Bureau employees. Just as short-sighted, unyielding administration is forcing price control into the same category as prohibition—a situation in which getting away with something is fair game—so similar administration has forced taxpayers into a position where their natural reaction in the preparation of their tax returns is "Oh well, let's try it on, the Bureau will try anything it can."

Comparison with English System

We do not need to be Anglophiles to admire the comparative quiet with which the English tax law is administered, the comparative graciousness with which the average English business man pays his tax. Why is the comparison of administration so unfavorable toward the U. S. system? Because the Englishman has confidence in the Board of Inland Revenue and in the reasonable and fair administration by its inspectors.

The contrast between the administrative systems has long been recognized. In fact, in 1934 a comprehensive report upon the British Tax System was submitted to the members of the Joint Committee on Internal

Revenue Taxation by a commission headed by Prof. Roswell Magill, then acting as special assistant to the Secretary of the Treasury. This report emphasized the ease of English administration. It was most complete and I would like to present the following quotations therefrom:

> The keynote of the British revenue administration is decentralization and the pivotal figure is the local inspector or surveyor of taxes . . . An inspector who did not reach an agreement upon the liability with the taxpayer in the great majority of cases without any further reference or appeal, would certainly be regarded as falling below the normal standard of efficiency . . .
>
> . . . Ordinarily the inspector does not examine the taxpayer's original books of entry, but relies upon statements prepared and certified by accountants who have audited the taxpayer's books . . .
>
> In conclusion, the success of the British system seems to turn in the end upon the high caliber of the inspectors, upon the general reliability of the information furnished them by the taxpayer, particularly as regards accounts certified by professional accountants, and upon the desire of the inspector and the taxpayer to arrive at a correct and equitable determination of the tax liability at an early date. There seems to be a general satisfaction with the operation of the system, as well as a conviction that the amounts of tax legally due are being collected.

The conclusions and recommendations for improvement which close the report of Professor Magill's commission include the following summary statement:

> Revision of the law in a way which will give more recognition to equitable principles and which will allow it to be administered with less regard to technicalities would be extremely helpful.

The foregoing recommendation was fine, except that it implied the necessity for a revision of the law. Such an implication is unfounded. Sufficient administrative leeway was and is at present available to eliminate the disruptive, annoying procedures without any noticeable effect on the revenues.

To prevent a charge of unsupported generalization, let us look at the items which cause the greatest difficulty and disruption when a return is being examined. Would an effort to administer reasonably and without disruption, rather than an effort to collect the last penny regardless of reasonableness, be possible in these cases?

Depreciation

Here is an item which the law itself specifies should be a "reasonable allowance." Exactitude is an impossibility. Yet within recent months I have seen a taxpayer put to the trouble and expense of preparing voluminous schedules, retirement reports, engineering studies, etc., in an effort to sustain a composite rate of 3½ per cent on several millions of dollars of assets, only to have the Bureau say that a proper rate was 3¼ per cent. In other words, the omniscient Bureau knew that the average life of several thousand different articles was about 369 months, not about 343 months. That is jut being a deliberate nuisance in order to collect some tax. That is not sound administration and does not indicate any consciousness of a responsibility to be reasonable. This may be an unusual example in its severity but it exemplifies a regular, everyday happening.

Several years ago, Colonel Robert H. Montgomery suggested that provisions for depreciation which were made in corporate income accounts, certified to by independent accountants and accepted by creditors and stockholders, along with management, as a proper provision for depreciation, should be accepted as reasonable allowance by the Treasury. Many Treasury officials ridiculed this suggestion as being solely a self-serving suggestion by an accountant. However, as a deduction for depreciation which is reasonable is all that can be expected and is all that the statute calls for, it is submitted that the suggestion should have received more consideration by the administrative officials for the Bureau and less off-hand ridicule.

Compensation

Here again we have a statutory provision for a "reasonable allowance for salaries or other compensation . . ." In fact, it is very questionable whether, at the time this provision was originally written into the law, there was any thought that the Bureau would superimpose its judgment as to what was reasonable. As has been recently pointed out by Professor Griswold in the *Harvard Law Review* (December, 1945, page 286; P.H. 1946, par. 70431), the phrase "including a reasonable allowance for salaries . . ." was added to "All the ordinary and necessary expenses paid or incurred . . ." to cover the situation where an insufficient amount had been provided for, not an excessive amount. However, I do not ask for a return to that concept now. I do ask that a "reasonable allowance" be accepted, and I seriously question the benefit—under a free-enterprise system—of allowing the Commissioner (or, more particularly, an admittedly underpaid examining agent) to determine what is reasonable. Even from a purely legalistic viewpoint, under a free enterprise system, how can the testimony of anyone not directly connected with a business be competent as to what is reasonable compensation for that business to pay?

The question of reasonableness of compensation should not be confused by argument about those few cases in which salary payments are used to cover what are, in reality, gifts or dividend distributions. The right of the Commissioner to disallow in such cases is not questioned here. But where the officer or employee is not a majority stockholder and is admittedly performing the services for which he is employed, the Commissioner, if he were sincerely attempting to administer the tax law with as little disruption to business as possible, would severely criticise the nuisance-use of a proposed disallowance of this item by agents.

It has been advocated for some time that the statute be changed to provide that when salary disallowances are before the Tax Court that the burden of proof be placed upon the Commissioner. However, since we are discussing reasonable, considerate administration without statutory change, why would a proper administrator not accept as reasonable any compensation allowance which was not so unreasonable as to make the question of burden of proof unimportant?

In the case of no other deduction is the arbitrary, unnecessarily harsh, disruptive attitude of the Commissioner and his cohorts so discernible as in the case of the deduction for compensation. Despite the fact—and it is a fact—that neither the Commissioner nor any other employee of the Bureau is qualified to evaluate the services rendered by an employee or officer of a thriving business; despite the fact that the Commissioner loses a very large percentage of the cases before the Tax Court on this issue, business is continually harassed with threats of compensation deductions.

Proper Tax Accounting

Here again we encounter a continued source of annoyance to business, a continued example of unsympathetic, arbitrary, unreasonable administration. When should items of receipts, or possible receipts, be included as taxable income? When should deductions be taken for expenses incurred? What authority for reasonable administration does the Commissioner have? Is legislative action necessary? Section 41 of the Internal Revenue Code now provides:

> The net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; . . .

Section 42 (a) goes on to say:

> The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period* . . . (Italics supplied)

The foregoing "unless" clause has been interpreted by the Treasury to mean that sometimes income must be reported before it is received, but that it can never be deferred as unearned and reported subsequent to receipt. There is absolutely nothing in the statute that says so! Despite all the fallacious arguments to the contrary, there is no statutory denial of the acceptance of sound accounting principles. Certainly nothing can be more confusing, nothing can be more productive of discontent, nothing can be more destructive of confidence in tax law administration to the business man who has established a sound accounting system acceptable to himself, his associates or stockholders, his creditors and his accountants, than to be told that net income for tax purposes is something other than what his books show.

Admittedly, the courts are responsible to a great extent for the continuance of this disruptive condition. Approaching the matter with purely legalistic minds, the courts have sometimes upheld the Commissioner in his interpretation. However, this does not serve to excuse the fact that if a reasonable, helpful attitude had been taken by the Commissioner, the cases would not have been before the courts in the first place.

Similar issue can be taken with the manner of administration in many other respects, but continuation seems unwarranted. The foregoing examples of lack of sympathy with the problems of business are only a small sample but they are indicative of a fault which should be corrected.

Summary

Repetition is necessary for purposes of summarization. A sound tax program, when related to a system of free enterprise, is not a question of rates or of subjects of taxation.

To be sound it must be based upon real needs and not social theories. Any purpose other than revenue raising must be avoided as much as possible, not promoted. Primarily, it must engender confidence and stability, not provoke insecurity and discouragement.

Rates of tax will become secondary when our tax administrators conduct themselves as though business were entitled to reasonable and conscientious understanding, not as though business was a bad boy continually without trustworthiness and needful of strict disciplinary action.

FOURTH SESSION

FRIDAY, MAY 17, 1946 — 7:00 P. M.

DINNER SESSION

Deshler-Wallick Hotel

Chairman:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Introduction of honored guests

Responses

Address: "Real Wealth Versus Money"

LOUIS BROMFIELD, *Author, Lucas, Ohio*

REAL WEALTH VERSUS MONEY

By Louis Bromfield
Author, Lucas, Ohio

Few people realize or understand that very close to 50 per cent of our population is dependent upon agriculture as the source of its income and employment. Actually only about 20 per cent of the population is engaged directly in a more or less productive agriculture, but agriculture and the productivity of our soil lies at the base of the great agricultural machinery business, the greater part of the mail order house business, large segments of the gas, oil, rubber and steel industries, the vast milling and packing house trades. It provides a great portion of the revenue of our railroads, and is the economic base of virtually all our small towns and cities as large as Omaha, Kansas City, Des Moines, Montgomery, Alabama, Minneapolis, and countless others. It supports largely whole segments of the "servicing" in the form of the filling stations, garages, department stores, etc., which have become so important an element of our highly industrialized national economy. Therefore, agriculture—a good, productive agriculture—becomes of vital importance not only from the point of view of employment but also from the point of view of the agricultural purchasing power which largely supports industry and, in turn, provides employment and, consequently, the additional purchasing power of the great segment of industrial workers. In other words, when farmers cannot go to town to buy tires or radios or automobiles, it means not only that hundreds of thousands of industrial workers are thrown out of work in Pittsburgh, Detroit, Chicago, and elsewhere but that *their* purchasing power is, in turn, curtailed sharply or cut off altogether.

Likewise, if we have a poor agriculture which produces commodities either in too small quantities or through inefficiency at high prices without profit, the consumer's market becomes limited by the increasingly high prices created by scarcities or the high cost of inefficient production, and consumption is limited with a depressing effect upon the employment based upon agricultural production and, consequently, upon the purchasing power of the non-agricultural element dependent upon agriculture for employment.

It might be said with considerable truth that every depression we have experienced since the Civil War has begun at the agricultural end, with the shrinking or disappearance of the purchasing power of the agricultural segment of our population, and spread through the whole of our national economy.

In the past when the agricultural segment represented two or three times the current percentage of our total population, the fluctuation of prices and occasional surpluses had something to do with the prosperity and purchasing power of the farmer. Today this is much less true and is becoming steadily less and less true. This depression of prosperity and purchasing power is caused today much less by prices or surpluses than by a poor and declining agriculture of constantly decreasing yields per acre and steadily increasing cost of production per bushel of grain, bale of cotton, quart of milk, or dozen eggs.

One of the great errors of agricultural economy has been to think of agricultural production in terms of *total* production rather than in terms of production *per acre*. During the war we achieved a record of *total* food production but never in any country at any time has food been produced so expensively—so expensively indeed that even with high prices it has been necessary to create subsides (paid in the end by the consumer out of his pocket in the form of taxes) in order to get sufficient production. This is so because the cost of production per acre or per bushel was so high.

That cost has been increasing steadily since the first furrow was turned on this American continent, for the simple reason that the production per acre has been steadily declining. In the corn belt, areas which once produced as virgin soil, without fertilization, yields of 120 bushel per acre, averages have declined within the past few years to as low as 37 and 44 bushels per acre. In the cotton areas, where in acre once produced two bales of cotton, some cotton farmers are today farming six or seven acres to produce one bale. Beyond that point, even with parity prices and subsidies, cotton can only be produced at a loss and the land is abandoned to weeds and scrub oaks and pine. There are millions of acres of such land, producing no real wealth, employment or purchasing power, and in many cases paying no taxes either to county, state or nation. The annual production of wheat in this country is only twenty bushels per acre as opposed to sixty bushels in France. And so it goes all along the line.

Let us examine what this declining production really means, first, to the farmer himself, his prosperity and his purchasing power and, second, to the nation itself.

It is perfectly clear, I think—as simple as the addition of two and two—that the corn produced by a farmer who gets yields of only twenty bushels per acre must cost him five times as much to produce per bushel in terms of labor, seed, taxes, interest, wear and tear, and possible fertilizer as the farmer who produces 100 bushels on one acre. The farmer who produces two bales of cotton on one acre can produce it approximately ten times as cheaply as the farmer who produces one bale on five acres. In other words, the good farmer—the 100 bushel, two-bale-per-acre farmer—is always five to ten times as well off, regardless of prices, than the poor farmer producing low yields per acre. If prices are high, the good farmer is rich; if they are low, he is always solvent.

These estimates and the mathematical formula regarding declining production per acre and increasing cost of production hold equally true in relation to forage crops, to pasture production, all the way through the cost of a quart of milk, a dozen eggs, or a pound of meat, etc., as well as in relation to the farmer's profits on all of these items. The speaker knows the question, from the manure spreader and the plow upward, as a dirt farmer interested in practical economics. In an adventure devoted to the rehabilitation of 1100 acres of farm and grazing land we have been able to increase production from 50 per cent to 1500 per cent per acre from a very low level. In our Ohio country, on grazing land which once required from 10 acres upward to carry a cow or a steer through the summer in poor condition, we have raised some pasture land, through the use of minerals and pasture mowing, to a carrying capacity of two and a fraction head *per acre* with steers pastured on it increasing weights in growth and meat from 250 pounds upward during the grazing season. The results and increased profits in terms of taxes and interest per acre alone need scarcely be explained.

This question of declining production per acre or per bushel, and increasing cost of production per acre or per bushel—which operates according to mathematical law—lay at the root of the ruin of many farmers who sought to expand their production in the period of high prices during, and after, the First World War. Their error lay in expanding horizontally rather than vertically.

Let us examine what this means. According to informed authorities of the Department of Agriculture, only about 10 per cent of our farmers produce anything near to 100 per cent of potential production per acre through a good and efficient agriculture. These are the 10 per cent who largely feed our immense urban populations. Another 30 per cent produce from 50 to 60 per cent of potentiality. The remainder produce little or no more than they consume. They are the marginal and submarginal farmers who produce little or no real wealth, pay few taxes, and, in many cases, are liabilities rather than assets to the whole of the nation's economy. Each year their number dwindles as they are forced on to the road to become migratory workers, paying no visible taxes and living part of the time on relief, or into the great cities as industrial workers to be cared for in times of depression or even of average employment. In some states, where the average cash farm income is as low as $160 to $170 a year, some of these families see as little as $5.00 a year in actual spending money. Their value, to the nation's economy, becomes, in view of vast government expenditures to bolster agriculture, that of liabilities. In the lowest categories their cash incomes and its insignificant effect as purchasing power, or to bolster industrial employment by buying industrial commodities, becomes negligible, or is entirely wiped out by the fact that we spend on agricultural agencies in this country approximately $13.00 per person—not per farmer but per person of the agricultural population. In few other ways can the cost of low agricultural production per acre be better illustrated.

But to return to the question of horizontal as opposed to vertical expansion and its evil effect upon the economy of the farmer, let us take one of those farmers who is what might be called an average "good" farmer—the 30 per cent who produce from 50 to 60 per cent of what they might produce per acre if they were really good and efficient farmers. Let us suppose that John Smith, of this category, owns 200 acres and wants to increase his production because corn or wheat or cotton are bringing high prices. Instead of staying home and producing the 40 to 50 per cent more he could produce on his own 200 acres at very little increase in the cash cost of production per acre, he goes out and buys 200 more acres of land. As a result he had not increased his production per acre. He probably farms his whole 400 acres less well, so that he produces less per acre both on his original 200 acres and on the 200 he has purchased, while his cost of production remains the same or has probably increased. This is especially true in war or boom times when labor and machinery are scarce and the cost of whatever he purchases or hires to cope with his increased acreage, including the price of the new land he has purchased, have risen to abnormal heights. He has possibly borrowed money or mortgaged to purchase the additional two hundred acres, or used capital which could be much more profitably used as a reserve or to increase the productivity per acre of his original 200 acres.

When war and boom prices begin to fall, John Smith is caught. He has expanded his production horizontally rather than vertically and finds his comparatively low production per acre unequal to the job of paying additional interest and taxes and mortgage payments. Banks and insurance companies need the money and eventually are forced, by a deflating economy and legal circumstances, to foreclose, acquiring thousands of acres which they do not want, cannot sell, and which cost them money to operate. And the foreclosure takes place not at the level of high prices which John Smith paid for the additional 200 acres but at the deflated prices of a period of depression of all 400 acres, and John Smith is wiped out.

That is the story of millions of acres of farm land during the deflationary period which followed the war boom of the early twenties. If John Smith had stayed at home and increased his production by the 40 to 50 per cent he could have done, the margin would have been almost pure profit, with no additional taxes, interest or mortgage payments. He would have been solvent and even prosperous with his 100 per cent potential production per acre off-setting much or all of the decline in prices. By increasing his acreage and expanding horizontally, he ruined not only himself but lost altogether the purchasing power so vital to the general employment and industrial economy of the nation. Eventually, industrial workers are thrown out of employment because John Smith and his fellow farmers cannot buy the commodities manufactured by industry and, in turn, *their* purchasing power is not only cut off but they go on relief, paid for out of taxpayer's money and capital, which should be used to provide new enterprises, new employment and new markets. That is the story of some millions of acres of agricultural land during the deflation that followed the First World War, and largely speaking it is the story of the effects of decreasing agricultural production per acre everywhere and at all times.

The tradition of horizontal expansion, like that of poor farming, has grown largely out of the history of a nation with the largest pool of virgin natural resources and real wealth for its size in the world. We farmed poorly and greedily for the past 150 years because we could afford to do so. We had what appeared to be unlimited acres of rich, virgin agricultural land. If a farmer mined one farm, he had only to take another further west and mine that one and then another, for free or at most for a dollar an acre. In that process we have destroyed one fourth of our good agricultural land beyond use save as possible forest land. Another fourth is on the way out and the rest, save for small areas of land owned by intelligent and wise individual farmers, is subject to the same depletion of organic material and minerals, to the same soil erosion that has created such havoc with our agriculture and national economy.

Following previous wars, even up to 1918, there was always free agricultural land to be taken up by veterans as a reward for their services. Today there is none and we are paying, all of us, including the veterans themselves, out of our own pockets, taxes to make up the recompense. It can be said that no country in the history of the world has ever destroyed its real wealth in the form of agricultural land and forests as rapidly as this one. This destruction manifests itself not only in actually destroyed land, in increasing numbers of marginal and sub-marginal farmers and dispossessed farm families who take to the road or migrate into our already overcrowded cities—it manifests itself also in steadily increasing costs of food, the basic item in the cost of living, in consequently declining standards of living, in constantly increasing demands for raises in industiral wages and the prices of manufactured commodities.

The destruction and declining production of our agricultural land lies at the root of a creeping inflation that has been in progress since the Civil War and which in the long run will be more devastating to the health, living standards, incomes and prosperity of the nation than any temporary war time or artificial boom inflation. We are approaching a subsidized agriculture. Indeed many agricultural commodities are already subsidized. If we pay increasing prices for agricultural commodities across the counter, we are starting the inevitable vicious spiral of increasing wages, increasing prices of industrial and agricultural commodities, which constantly lowers the purchasing power of the dollar and the standards of living of our people. As agricultural production per acre declines and costs increase and as our population increases, we are moving exactly along the path which brught ruin to Chinese government, economy and civilization.

If we pay higher prices in subsidies rather than in cash across the counter, we are taking money out of the pockets of our citizens, through increasing taxation (either visible or invisible), and then constantly decreasing their purchasing power and draining way the capital which should be employed in a free nation, and under a free enterprise system, to bolster its economy by providing employment and developing its real wealth. One of the foolish illusions held by many people along with the illusion that money is real wealth, is that scarcity and high prices mean prosperity and high living standards. Exactly the opposite is true . A large part of government regimentation has grown out of an effort to deceive ourselves into believing that we are maintaining our living standards by government bribery of the people, by subsidies, and by high tariffs which are essentially no more than subsidies. We tax ourselves more and more in order to hold down living costs, devouring our economic vitals to do so and bringing ourselves constantly nearer to totalitarianism government, regimentation and a lower and lower standard of living. We are trying to deceive ourselves into the belief that we still possess vast resources of real wealth in the form of natural resources, and that these reserves are still highly productive. Neither asumption is true. The truth is that, in the face of a rapidly increasing population, we have destroyed our natural resources more rapidly than any other nation in the history of the world, and we are rapidly approaching the economic pinch and the lower living standards which have existed in Europe for three centuries and in China and India for an even longer period.

Our wealth, our economy, our power as a nation are not founded upon the gold buried at Fort Knox but upon our real and natural wealth. It, therefore, becomes imperative that we make the best possible use of the real wealth in the form of minerals, ores, oils, etc., and that we barter our manufactured commodities, either directly or through the use of money and exchange in a three- or four-cornered form of barter, for these raw materials and real wealth which we have utterly dissipated or never possessed. This is true even if we did no more than to stockpile these lacking raw materials against future use to bolster our economy and the real sources of our high living standards.

In all the vast pool of natural resources and real wealth which this country once possessed, agricultural land and forests are the most important and vital. This is so primarily because they are the sources of real wealth which are, if properly managed, constantly renewable and constantly productive of more real wealth. This is also true because as the supply of minerals, oils, etc., becomes more and more depleted, we turn more and more to agriculture and forests for the substitutes which can replace them. Our productive forest areas have been reduced to less than a sixth of their original size and, during the war, we cut down our forests approximately five times as fast as we have been replacing them. Fire in unmanaged areas takes each year a terrible toll. We have destroyed a fourth of our good agricultural lands and are constantly wearing out, through erosion or poor farming, what remains to us of this, most precious of all, our real wealth and natural resources.

All of this was what Bernard Baruch, greatest of the world's practical economists, was talking about when he made to Congress what was to this nation perhaps the most important statement of our generation and century—a statement which was largely overlooked and seems already forgotten. It was this—that we had best make an invoice of the real wealth and natural resources which are left to us before we went on distributing them around the world with a lavish hand in the form of manufactured commodities either for free or for money. Mr. Baruch knew what all of us should know; first, the real basis of our wealth and power is our natural resources; and second, that money paid in exchange for these resources, either processed or as raw materials, only creates inflation and shortages and lowers living standards, unless this money is in turn spent outside the nation for raw materials and real wealth, which is the very heart's blood of nations in the industrial age in which we live.

What we need in this country is not *more* dollars but dollars which *buy* more and more, and we shall only get dollars which buy more through intelligent use of our natural resources and real wealth. We shall only get dollars which buy more and more and raise, rather than lower, the living standards of our people, through abundance with greater production, lower costs and profits for all. Each day our dollars buy less and less and each day there are new strikes, new demands for higher prices for industrial commodities and higher ceilings and parities for the farmer. In all of this both production and abundance suffer and, as scarcities increase and prices go up, living standards and prosperity decline.

I am certain that the lips of some of you are already forming the word "surpluses." Surpluses, like so many other shibboleths of our day, are an illusion. For at least two generations in this nation there has never been any such thing as a surplus, save in a few single crop areas where men have stubbornly gone on producing year after year the same commodity, despite falling demands in the world as a whole. Cotton is the pre-eminent example. When, coupled with a declining demand, the costs of production increase and the yields per acre decline, a surplus is inevitable, especially in the face of world competition.

But in the realm of food, there is no such thing as surpluses in a world where three quarters of the population suffer from malnutrition and a quarter of it is born and dies without ever having had enough to eat for one day of its life. There is no such thing as surpluses in a nation like this where, despite potentially great agricultural resources, 40 per cent of the population suffer from malnutrition, either because of ignorance or because it cannot afford to buy high quality protein food. There is no such thing as surpluses; there is only poor distribution and prices which are too high; and the prices are high because of a poor agriculture, and declining yields per acre along the whole range of food and feeds.

Never in the history of the world has the folly of the "surplus" theory with regard to food been so tragically exposed as at the present time. While half of the world starves, we are experiencing, actually, shortages in this country. The truth is that if our government representatives and officials spent half as much time on better production and better distribution of food commodities, both here and abroad, as they spend in patching up price regulations, tariffs, parities, etc., we should have a market, both in this country and in the world, which would consume, at good prices to the farmer, much more food than we can possibly produce at the present time. There could and should be some system by which the food of the world can be distributed properly either by direct barter or through the use of exchange, with economic advantage to all concerned. It is one of the things which should concern our State Department, our Department of Agriculture and most of all, perhaps, the United Nations Organization. To talk of agricultural food surpluses in this country or in the world is absolute nonsense. It is an excuse made by politicians who seek to buy their votes with the use of taxpayers' money and who have not the brains or initiative or energy to find the true and fundamental solution—better distribution and greater not less production per acre.

Those who talk of surpluses overlook nearly always the factor of high prices and their constricting influence upon markets. In other words, with beefsteak at 25 cents a pound, as against 85 cents or a dollar a pound, the consumption would increase at least twenty times and, under existing conditions, it would be impossible for the farmer or cattleman to satisfy the demand. The same is true to a greater or less degree of all foods.

Certainly, under existing agricultural conditions, costs of food can scarcely be reduced overnight without disaster to the farmer, but that is so because it costs far too much per acre to produce a bushel of corn or a pound of meat. The change cannot be made overnight. We have made a good start in certain areas of the country but a really efficient, profitable and prosperous agriculture, without subsidies and such panaceas, can only be achieved over a period of years.

Since the Civil War the economic history of the nation has been largely that of violent booms and violent depressions, violent inflations with short periods of doldrums in between. There has never really been a period of genuine and stabilized prosperity in which the farmer, the business man, the manufacturer could plan, with any certainty, for more than a couple of years ahead. Such a stabilized prosperity is what we need, and only abundance, low prices and a stabilized purchasing power for the dollar will give it to us. All that, of course, is based upon the proper care and employment of our real wealth and natural resources. The money will take care of itself.

In our basic triumvirate of agriculture, labor, and industry, the best place to make a beginning is with agriculture. In an agriculture such as is practiced in Denmark, Holland, Belgium and France, with a 100 per cent production per acre, there is no such thing as a poor farmer, even in bad and disturbed times. The agricultural wealth and solidity of these nations lies largely behind the fact of their stability and rapid recovery, as compared to a nation like the United Kingdom, which lacks both the real wealth and the purchasing power of a sound and productive agriculture. If we had in this country as efficient land use as in these nations, the cost of food and of other agricultural commodities could be reduced as much as 30 per cent, or more, and the farmer would be making 20 per cent more profit than he is making today. It is largely a matter of production per acre.

Subsidies, tariffs, parities, price ceilings, bribes to agriculture—all of these are makeshifts which deal with effects rather than causes. They solve nothing, but only continue to undermine our prosperity and living standards. Because of the gravity of agricultural conditions at the present time, some of these measures must be continued in one form or another. Some of them must be continued so that the farmer can be helped to help himself. But in the long run they are no more effective than a plaster placed on the outside of the stomach to cure a stomach ulcer. The real answer is the stopping of floods and soil erosion—either by wind or by water—better and more productive grazing lands, and a better and more productive agriculture—in short, abundance with low production costs and the guaranteed security which comes of high production per acre. What we need as a nation is dollars that buy more and more for everybody—farmer, industrial worker, business man. We shall only get that through abundance in all our production—agricultural and industrial. What we need is corn at 50 cents a bushel, with a good profit margin, rather than subsidized corn at a dollar a bushel, produced at a loss to the farmer. There is one way to get all this and that is through the preservation and restoration of our greatest source of real wealth—the soil—through better land use.

FIFTH SESSION

SATURDAY, MAY 18, 1946 — 10:00 A. M.

Commerce Auditorium

Chairman:

ERIC L. KOHLER, C.P.A., *Chicago, Illinois; President, The American Accounting Association*

Address: "Financial and Operating Reports for Stockholders"

T. DWIGHT WILLIAMS, C.P.A., *Oklahoma City, Oklahoma; President, The American Institute of Accountants*

Address: "Financial and Operating Reports for Management"

FRANK KLEIN, *Vice President, Worthington Pump and Machinery Corporation, Harrison, New Jersey; President, The National Association of Cost Accountants*

FINANCIAL AND OPERATING REPORTS FOR STOCKHOLDERS

By T. Dwight Williams, C.P.A.
President, The American Institute of Accountants

The accounting profession recognizes its responsibility to make corporate financial statements useful not only to the trained analyst but to a reasonably intelligent and experienced business man. This year we celebrate the 50th anniversary of the New York C.P.A. Law, the first in this country. It is a fair statement, I think, to say that during most of this period a constant effort has been made, by both corporations and independent public accountants, to make stockholders' reports more comprehensible to the average person. I think it is only fair, too, to say that it should be understood that corporations' annual financial statements are technical accounting reports and while the profession is constantly striving to improve and simplify them, it probably will be impossible to put them in such form that they can be adequately understood by persons with no knowledge of business or accounting techniques. Because of this fact it is important that the basic information pertaining to the operations of the corporation be presented in such a manner that the net income for the year is not so distorted by accounting techniques or qualified by footnotes as to make them of no value for comparative purposes, except, perhaps, to the experienced person who may have the qualifications necessary to, in effect, make a restatement of the net income.

During the past ten or fifteen years there has been a decided shift in emphasis in financial reporting from the Balance Sheet to the Income Account. Just how great this shift has been may be illustrated by the remarks of the Chairman of the Institute's Committee on Accounting Procedure before a meeting of the New York Society of Security Analysts. He said, "How far that emphasis has shifted, you know as well as I, and I venture the assertion that for most listed companies you pay little attention to the Balance Sheet, except as it throws light on the income statement. Even commercial bankers in making a loan are forced to consider the propriety of the loan from the standpoint of the operations of the borrower, rather than from the assets and liabilities of the company."

Again in a recent article by Mr. George O. May and Mr. Henry T. Chamberlain we find the following: "Net income for the year is a term of wide and great importance. It occurs constantly in the financial press and in the investment services, in annual reports, and in prospectuses. It is to be found in contracts relating to the compensation of management, to interest on income bonds, dividends on noncumulative preferred stock, and other kinds of conditional payments. . . .

"Since 'net income for the year,' or the average for a short period of years is, in practice, usually a major factor in the computation of capital values of equity securities, the precise sense in which the expression is used is a matter of great importance. Such securities are commonly valued at a multiple of the average. As the multiplier is increased the importance of the method of measuring net income for the year increases, perhaps to such an extent as to make a change in method desirable."

This shift in emphasis to the Income Account is significant because it has brought with it many problems that are the subject of most of the current accounting discussions. Some of these are the preparation of income statements and the propriety of charges and credits to surplus, valuation of inventories, treatment of war expenses and losses, and accounting for fully amortized war facilities having a substantial remaining useful value.

An examination of approximately 109 annual reports of "industrial" companies whose fiscal years ended subsequent to July 1, 1945, indicates that there is a wide area of differences in the treatment of most of these items. It was with the view or narrowing this area of differences of practice, and of developing criteria for new practices to meet the problems arising from the increased importance attached to the income statement that the American Institute of Accountants established a research department and organized a Committee on Accounting Procedure. All of you are familiar with the work of that Committee, and most of you know that at present it has under consideration the above questions and many others.

One of the problems which the Committee is attempting to answer is the nature and purpose of the income statement and the related question of the propriety of charges and credits to surplus. Of the 109 statements reviewed it was found that 45 companies had reported charges and credits to surplus for items other than balances transferred from the income statement, dividends, and transactions involving capital shares. Such items included transfers to-and-from postwar, contingency and other reserve accounts, adjustment of prior years' income taxes, adjustment for accelerated amortization on emergency facilities, renegotiation funds, and depreciation adjustments, as well as several other items.

An examination of these reports clearly indicates the problem. There are those who feel that the purpose of the income statement is purely historical and that a series of annual statements should include all the items of income or expense for the period covered. Others argue that the year's statement should be as significant as possible, excluding items not related to the operation of the year. A subcommittee of the Committee on Accounting Procedure has concisely stated the problem as follows: "The question of what constitutes the most practically useful concept of income for the year is one on which there is much difference of opinion, resulting in wide differences in practice. One of the concepts is that the net income for the year should be measured by deducting from the accumulated net income up to the end of the year the amount accumulated up to the beginning of the year. Another, and an entirely different concept, is one which emphasizes the relationship of items to the operations and to the year excluding from the income account any important items which are not so related."

It seems that a position could be adopted which, while making the statement useful to the public by clearly reflecting the operations of the year, would at the same time eliminate the error of constantly overstating income of one year and correcting it by surplus charges in a subsequent year. This could be done by grouping the items reflecting the year's operation and arriving at the net income for the year. This figure could then be adjusted for items pertaining to the operations of prior years or other items unrelated to the year's operations, transferring the balance to the Surplus Account. Just what this latter figure would be called I do not know. This then would leave as the only items to be handled through the Surplus Account, the amount transferred from the Income Account, dividends, and transactions involving capital shares.

Another method of treatment would be to give the same prominence to the income of the few years prior to the current year as is now given it. If this is done, corrections of the prior years' operations, not shown in the current year, would be reflected in adjusted statements of income for the prior years.

Ordinarily there should not be many such items but, probably for the next few years, *net income for the year will have little significance unless items pertaining to the war period are eliminated from the annual statement of net income.* In this connection it may be interesting to note that of approximately 109 annual reports reviewed, only two contained restatements of the income for the five-year period 1941 through 1945. This, notwithstanding the fact that 20 of the reporting companies made transfers to-and-from contingency and postwar reserves, 5 reported adjustments to the Surplus Account for accelerated amortization on emergency facilities, and 4 for renegotiation refunds.

Another problem which has caused much discussion during the past few years, and which has been made particularly acute by the prevailing high tax rate, is that of reporting income to stockholders on a *basis different from that used for determining taxable income.* I am not speaking of the differences inherent in the tax laws and therefore applicable uniformly to all years, but of the differences caused by adopting an accounting policy, relating to specific transactions, which differs from the tax treatment accorded those items. One example, cited in the "Committee Bulletin," is to charge loss to a previously provided reserve, and thus exclude it from income, while at the same time, reducing, by the amount applicable to the loss, the provision for taxes in the Income Account. Such treatment results in the income statement reflecting a higher net income for the year than would have been the case if the loss had not been sustained. Obviously, a fair presentation of the year's operations requires that an amount equal to the tax saving on the loss be charged against income and not against the reserve. The position taken by the Committee with respect to these items has caused a great deal of controversy, involving principally the method of presentation. It is interesting to note that while the SEC, in its Release 53, disagreed with the presentation made in the particular case which followed the first method set out in the "Committee Bulletin," it did find the second method prescribed therein as acceptable, and it supported the basic principle.

The complexity of the problems of accounting for postwar reserves is revealed by the treatment accorded them in the reports reviewed. Twenty-four of the companies increased postwar reserves by charges to income and 3 by charges to surplus, 12 credited portions of the reserves to income, 6 indicated there were no changes in the reserves in 1945, and 6 companies carried charges direct to the reserve account. These charges included renegotiation refunds to the government, reconversion expenses, accelerated amortization, additional federal income taxes of prior years, and a reduction in estimated postwar refund of excess profits taxes and inventory losses. Nine of the companies transferred portions of the reserves to income to cover charges included in costs and expenses. One company transferred to income the portion of the contingency reserve no longer required, and 2 companies transferred the balance of the reserve to surplus. One company transferred the reserve to earned surplus and applied it against reconversion expenses which were charged to surplus. These expenses were included in the income statement, but were eliminated from the final figure by credit for the amount of the reconversion expenses. One company increased its reserve for inventory losses and war contingencies by $175,000 charged to income, and transferred the balance of $250,000 from the reserve for additional federal income taxes which, it stated, was no longer required.

The possibilities of distorting income statements by improper treatment of postwar reserves is a matter of much concern to public accountants. Suppose a corporation discovers that it has an excess of one million dollars in its reserve account, created in 1943. May it by transferring this balance to its income account for 1945, a year to which it is clearly not related, increase the income for that year? Can the addition of one million dollars to its income for the year be adequately disclosed in the footnotes to the income statement? The Chairman of the Institute's Committee, in the paper previously referred to, discusses this question and says: "Perhaps it can, but the Committee believes it is better for that excess to be kept out of the statement of net income for the current year. There is, however, a school of thought that maintains that technique requires a consideration of how or where the reserve was provided, so there well may be companies which will return these unused reserves to income in the current year. We can hope that these will be few, and that the effect will be very clearly explained." Last March the SEC issued Accounting Series Release, No. 54, announcing an amendment to Regulation S-X which requires special disclosure of war costs, losses and expenses currently being recognized. The amendment requires that where war items are excluded from the income and carried direct to surplus or reserve accounts, the net aggregate of the amount so excluded shall be set out following the income for the period. It also requires disclosure of the nature, amount and treatment accorded the excluded items, as well as an explanation of the tax consequences where such costs and expenses are deductible in determining taxable income.

The amendment also requires a statement of the principle followed in classifying the excluded items as attributable to conditions arising out of the war or its termination. The Commission stated the amendment was necessary because of the variety of treatment given these items by reporting companies.

It appeared from studies made that many corporations had, during the past few years, set aside substantial amounts as reserves against anticipated but indeterminate costs and losses attributable to the war period. Most of these reserves were set up by charges against income, but in some instances, the charges were made against earned surplus.

In view of the fact that the Commission believes the problem will be of short duration and that by the close of the current year, most companies will be able to estimate, with reasonable accuracy, the further need for postwar reserves, no particular treatment was prescribed by it. The new rule simply required special disclosure as previously outlined.

You will remember that of the statement reviewed, 9 of the companies transferred portions of the reserve to income to cover charges included in costs and expenses and one company transferred to income the portion of a contingency reserve no longer considered necessary. I do not have information as to when or how the reserve so transferred was created. Five of the 15 companies charging war costs to reserves, or transferring reserves to income, indicated the use of the principles stated in Institute Bulletin, No. 23. A perfect example of the problem discussed in that Bulletin is that of relieving the income account of an amount equal to the taxes on reconversion expenses charged against a reserve created in a prior year but deducted in the income tax return for the current year.

Let us assume an extreme case. A corporation has a net income of one million dollars, but has reconversion expenses of one million dollars which it has charged against a previously created reserve. The reconversion expenses are deductible in computing taxable income so the corporation has none. If there had been no reconversion expenses, the corporation would have paid $850,000 in taxes, leaving a net income of $150,000. The Committee has stated that it is improper to leave the income statement reflecting at net income of one million dollars. It has suggested that it would be proper to charge the reconversion expenses to the income account, bringing into that account a portion of the reserve equal to the excess of the reconversion expenses over the tax reduction. In our example this would be $150,000. The important thing to be determined is that the method used really excluded all factors pertaining to the reconversion expenses, and does not have the appearance of making profits out of losses.

What treatment is to be accorded the unused portions of these reserves? In our example the unused portion of the reserve amounted to $850,000. If the suggestion that all items relating to income go through the income account with proper segregation of those items not related to current year's operations is adopted, this item would be cleared through the income account. It would, I believe, be preferable to restate the income statements for the years in which the reserves were provided.

In those cases where the reserves are not adequate to cover reconversion costs, it is not anticipated that any special treatment will be required. The principle is, of course, the same but the expenses for 1945, at least, were tempered by reductions of taxes at high rates. It would be proper, I think, to make a segregation of them in the income statement so as not to distort the current year's earnings, but no other treatment should be needed.

Of the income statements reviewed, 28 reported no data permitting an analysis of gross profit, 13 used the single step form of statement, 29 used a combined income and surplus statement, and in 25 the surplus statement appeared on the same page used to display the income statement. Thirty-four companies described that last item in the statement of income as "Net profit" (or "net income") for the year, and 35 compared the current year's operations with those of the previous year. Others used summarized statements to provide comparative income and balance sheet data. A few of the companies supplied resources and application-of-funds statements. Those noted were in the accompanying letter and were not a part of the financial statements.

Thirty-three of the reports reviewed contained references to emergency facilities. Two of the companies segregated in the balance sheet facilities completely amortized, 9 indicated the amount of the facilities but did not segregate, 18 reported accelerated amortization but the amount of the facilities was not indicated. One company eliminated the fully amortized facilities from the assets and reserve accounts. This diversity of treatment suggests the uncertainties and difficulties of an adequate basis and procedure for accounting for such facilities.

Much has been written recently concerning the treatment of these facilities that have a substantial remaining, useful life—the amount of which is relatively significant. Those who do not favor restoring these assets say that such treatment is akin to write-ups and may also place the concern in a poor competitive position if the restored costs are considered in determining prices. Those favoring the restoration argue that in many cases the fully amortized property will be comparatively new and perhaps the most significant, if not the only, property of the company; that financial statements of those companies cannot be very useful if there is no showing of the property on the balance sheet, and no charge for depreciation for the future use of that property. It has been stated that the Committee believes "it should be permissible for corporations to adjust the amortization written off when highly significant properties are involved, and, in special cases, where the new plants are a high proportion of the total, it may be quite desirable to do so." In making the adjustment, due consideration should be given to useful value, normal depreciation, and to the fact that future depreciation will not be deductible for tax purposes.

The Institute has long had the problem of inventory pricing under consideration. It is one about which there is a wide diversity of current practice resulting perhaps from a general confusion as to the purpose and application of the "lower of cost or market" rule. In July 1933 the

Institute appointed a special committee on inventories to consider every phase of the problem. Later the Committee on Accounting Procedure delegated the task to a subcommittee which has issued a number of preliminary and tentative statements designed to stimulate discussion of the subject by practicing accountants. These studies covered the field thoroughly and propounded a range of questions and suggested answers thereto.

During the war the study of the problem gave way to others more urgent, but since the end of the war the subcommittee has renewed its activities and has recently proposed a summary statement around which a bulletin dealing with the subject could be developed. One of the stumbling blocks in the way of reaching a conclusion has been a variation in the definition of the term "market." The committee, in its preliminary draft, included these alternative definitions of this term for consideration:

1. The term "market," as herein used, means primarily the current replacement cost (by purchase or by reproduction, as the case may be). It is subject to the exceptions that (1) such amount should not exceed the estimated realizable value after deducting costs of selling, and (2) it is not necessary to write-down below the amount which will, upon sale in the ordinary course of business, be realized with an approximately normal profit.

2. The term "market," as herein used, means the lower of replacement cost (by purchase or by reproduction, as the case may be), or realizable value (either in existing conditions or as incorporated in the product normally sold) after allowing for completion and disposal expenses, except that it is not necessary to write-down an inventory from cost to replacement when cost will be recovered with profit in the ordinary course of business.

3. The term "market," as herein used, means generally the amount estimated to be realized from sales, after allowing for expenditures or charges to be incurred before disposal. In many situations, "replacement" or "reproduction" costs may be appropriately used as an objective basis for estimating "market," as in the cases of inventory items representing raw materials, or when sale prices tend to vary directly and promptly with the cost of productive materials.

It is my understanding that the Committee is at present leaning toward the third definition. There is a feeling that any other interpretation would, in effect, be transferring a loss into the year in which the inventory was revalued, and creating an artificial profit in a subsequent year; thus, distorting the income statement.

It is not my purpose at this time to discuss all of the problems in connection with the valuation of inventories, but simply to point out that the problem exists, and reports to stockholders should adequately disclose the basis of pricing inventories, and that a method once adopted should be uniformly applied. It would, I think, be helpful if all concerns in the same industry were to adopt a uniform method of determining inventories. The stockholders' reports would be much more useful since their comparative value would be greatly enhanced.

Another phase of reports to stockholders is that portion designed to supply information pertaining to the relations of *management with the employees*. The importance of this relationship has been crystalized by the several disputes between labor and management since the war. You are all aware, I am sure, of the view expressed by some labor leaders that labor is entitled to information pertaining to costs and profits of employees. In some of the annual reports special attention was given to supplying information which should be of special interest to employees. In a few instances separate reports, designed to furnish such information, have been issued. Perhaps, by giving a little thought to supplying in the annual reports, information of interest to employees, a labor-relations job could be done which would help to create and cement friendly relations between the employees and the management.

It has been said many times that it is the desire of the accounting profession to make financial reports as significant and useful as possible. If annual, or more frequent, reports of the financial and production operations of a corporation can be so designed as to become a factor in the settlement of the many labor-management disputes now rampant in this country, certainly another step toward this objective will have been taken.

I do not mean by this that I believe wages should be based on the profits of a business. Profit sharing carries with it the idea of sharing losses, and would require that the compensation of labor fluctuate as profits and losses occur. This is not desirable. Labor should insist that its compensation be tied to production and not to profits.

This does not mean, however, that the workman has no real interest in learning about the operations of the business. He does have, and if information is supplied him through special sections of the stockholders report, or in a special report designed for that purpose, it is conceivable that labor-management relations would be improved.

FINANCIAL AND OPERATING REPORTS FOR MANAGEMENT

By FRANK KLEIN

Vice President, Worthington Pump and Machinery Corporation, Harrison, New Jersey; President, The National Association of Cost Accountants

Reports, as treated in this presentation, are compilations of factual data by which management obtains and imparts information requisite for the operation and control of a business. They are the means by which the owner of a small business knows whether his receipts and disbursements, as affected by his changes in open accounts, inventories, and other assets and liabilities, will result in profitable operations; they are the means by which an executive is able to comprehend the ramifications of a far-flung, industrial enterprise in all its operations and functions; and they are the means by which the story of plans and accomplishments is told at regular or irregular intervals in all the other business organizations that intervene between the very small and very large type of companies just mentioned.

It follows that the type of information, and manner in which it is reported, will be as diverse as the physical conditions it is attempting to depict. Reports, or presentations of information, can follow no fixed form, but should be designed to furnish pertinent or operating information in the language best understood by the person to whom it is supplied, and at the time when it is most effective.

Although we have just said there can be no fixed form for presenting various types of data, we touched upon several broad principles which should govern any presentation. An elaboration of these, the development of some additional guides, and a reference to some specific examples that conform to these rules should prove helpful.

We all know that overlapping responsibilities, or failure to delineate the activities of departments or individuals, lead to inefficiencies and confusion. It follows that when management has properly delegated authority and responsibility, the collection of data and its presentation must be along similar lines of responsibility if confusion is to be avoided. So the accountant must lay out his chart of accounts to compile operating information for each department head or supervisor who is charged with individual authority. If ten foremen supervise departments in the machining division, and each signs requisitions for labor and materials and is otherwise responsible for the costs and expenses of his department, then one accounting report of costs for the machining division will have little use for control purposes because the economics of one supervisor will be submerged with the inefficiencies of another, and neither they nor the superintendent to whom they are responsible will have the benefit of information showing their individual department's effectiveness.

Another point for the accountant to consider when preparing his chart of accounts is the manner in which the various types of expenses are segregated or classified by account names. For instance, one designation as "Indirect Labor" may be entirely inadequate to indicate where excess costs occurred when this labor may have represented shop clerks, crane men, oilers and cleaners, general laborers, etc. This is particularly important when determination is being made of the manner in which each type of work should vary with changing production volumes. The same is true of operating supplies and other departmental accounts.

If it is essential to provide for accumulation of information according to individual management responsibility, it is equally important to avoid the pro-ration of expenses from other departments, or the pro-ration of expenses that result from others' responsibilities. We have in mind the allocation of indirect, or service departments' expenses to production departments for burden absorption purposes, and the attempt to hold the final department responsible for its resulting over, or under, absorbed burden; or the merging of the causes of a plant's profit results, such as the booking of low profit business, the improper allocation of commercial expenses, the special trade discounts, the high shop costs, or the overhead, etc.

From what we have said thus far, it is apparent that our reports must discern for management the particular task assigned to each responsible head, the manner in which such tasks are being accomplished, and the way in which the aggregate of all activities are measuring up to the business objectives. It may simplify our discussion to consider a specific aggregation of reports which conform to some of the principles already mentioned; moreover, if we use for our example a company that manufactures and markets both standard products and a variety of equipment built to the customers' specifications, we will probably cover many of the conditions encountered in a representative cross-section of industry.

Report of Unbooked Capacity

First, management must know, under present peak demands, what volumes of its several products the going plants are capable of producing.

For this purpose a columnar-ruled sheet will be prepared by the works production department, listing on the left side each type of kind of product that the plant manufactures. There will be from 13 to 26 columns to provide for one 12-month period, or perhaps for two years. On the first line for each product there will be shown in each monthly column the fixed volume that the productive facilities are capable of turning out in a standard work-month.

On the second line will be shown the volumes of unfilled orders, scheduled ahead for shipment by months. The difference between the two lines will represent the unbooked capacity for any product by months for the current year and, if desired, for the coming one. If several products can be processed over the same manufacturing facilities, they will be listed together with subtotals showing when any combination of them equals their total capacity. This report of unbooked capacity is the production department's advice to the sales department of the ability of each works to produce specified volumes of products over any desired period of time.

In times of normal demand such a schedule prepared at the beginning of a year would serve as a guide in establishing the year's booking quota with, of course, due consideration being given to the available amount of each type of business. An additional schedule at mid-year would suffice, with individual advices, if any particular product's capacity showed a tendency to be oversold. Under present conditions monthly schedules would be prepared so that available capacity, on which delivery promises are dependent, may accurately be determined for two years ahead.

Booking Quotas and Sales Expenses

The sales department, having in mind the unbooked future product capacity, will determine, through contacts with its field and division managers, the volumes of each class of product that can be obtained by them. The field sales office will submit its proposed quota by both class of products and salesmen. The general sales department will then summarize all quotas, by lines of products, for reference to the report of unbooked capacity and, if necessary, quotas will be revised. When quotas are finally established, a sales expense budget will be determined with each office. This, then, is the measure of responsibility for each office—the volume and kind of work to be produced, and the expense appropriate for its performance. Th manner in which quota and actual bookings, and sales expense budgets and actual expenses are usually reported are matters of general knowledge and will not be described here.

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WORKS OPERATING RESULTS

Works__________
_____ Ending __________

BOOKINGS – BILLINGS – UNFILLED ORDERS	QUOTA	ACTUAL	UNDER–OVER QUOTA
Unfilled Orders Balance			
Net Bookings			
Net Billings			
Adjust. to Unfilled Orders			
Balance End of Month			

FINANCIAL	FIXED BUDGET	VARIABLE BUDGET FOR ACTUAL VOLUME	ACTUAL RESULT	UNDER–OVER VARIABLE BUDGET
Billings (Less Special Discounts, etc.)				
Less: Normal Shop Cost				
Under–Over Abs. Works Burden				
Other Shop Costs				
Total Shop Cost				
Gross Trading Profit				
Deduct: General–Administrative Expenses				
Selling Expenses				
Reserve for Uncollectible Accounts				
Other Charges – Net				
Total Deductions				
Net Works Income				

STATISTICAL	FIXED BUDGET ALLOWANCE	VARIABLE BUDGET FOR ACTUAL VOLUME	ACTUAL RESULT	UNDER–OVER VARIABLE BUDGET
Percent Operating Capacity				
Works Indirect Expenses				
Under–Over Abs. Works Burden				
Defective and Spoiled Work Cost				
No Charge Order Cost				
Total Def. Spld. Wk. & N.C.O. Cost				
Total Cost Per Billing Dollar				
Inventories:		FIRST OF	END THIS MONTH	DECR.–INCR. THIS
Finished Machines				
Manufactured Parts				
Material and Supplies				
W–I–P Net (Actual)				
Consigned Stock				
Total Inventories				

Works Operating Report

The type of report that can be most confusing to management, if its elements of responsibility are not segregated, is the manufacturing income statement or the works operating report. This is due to the fact that the Works manager is sometimes held accountable for a poor profit showing, or given credit for a good one, when different factors both within and without his control are responsible. As most companies have varying profit and loss lines, the kind of business booked for the plant contributes directly to the profit results; thus, a preponderance of better profit lines booked will enable the plant to show better operating results. Adequate volume is through dealers at quantity discounts, resulting in an uneven ratio of costs to prices for similar products. Operating capacity may be low, due not to also necessary for satisfactory profits, but let it be stressed here that for various reasons volume alone is not the cure-all for unsatisfactory profits. Some sales may be made direct to consumers at net list-prices; others, lack of volume but to internal plant difficulties. Shop costs may appear to be out of line, due to inadequate cost controls, or because of rising material and labor costs that could not be balanced by offsetting economies. Obviously these and other contributing factors must be unscrambled if management is correctly to appraise them and to supply the necessary corrective. A report of this kind, together with its schedules, should therefore attempt to show:

1. The quota and actual bookings by lines of products segregated into major profit groups, such as: Class A—Loss lines or normal profit of less than 2½ per cent; Class B, over 2½ per cent but under 7½ per cent profit; Class C, over 7½ per cent profit. If the quotas have been established to provide for a sufficient volume of fair or good profit lines, and actual bookings do not conform to this pattern, emphasis must be placed on better distribution.

2. The quota and actual billings by lines of products, segregated into similar profit groupings. While, after business has been placed on the books, it is too late to influence results, this segregation is essential for correct evaluation of operating results.

3. The income that should have resulted had the budgeted kinds and volumes of products been produced.

4. The income that should have resulted from the actual kinds and volumes of products produced.

5. The actual income results.

6. Analysis of variations.

While this may sound complicated, it can be reported on a relatively simple form, similar to the accompanying report of Works Operating Results which is summarized as follows:

A. On the upper section of the sheet one line is used to show the booking quota, actual bookings, and the variation. On a second line is shown the billing quota, the actual billings and the variation. Both the booking and the billing totals are supported by a schedule showing the quotas, actuals and variations, by each line of product and segregated by profit groups.

B. A second section of the form is used to show in conventional order the income from billings, the shop costs and other deductions, and the net income for the plant. But this section differs from the usual type of income report because it has four columns for reporting pertinent data regarding operations. In the first column is shown the income which should have resulted had the quota volumes and kinds of products been billed; this is the long-term or fixed income budget as established at the beginning of the year. In the second column is shown the actual billings and the appropriate costs and other deductions that should have occurred for the actual volume and kinds of products billed with the resulting budgeted income. In the third column the actual income results are stated. The fourth column shows the variations between the adjusted or variable budget and the actual results.

C. To determine the budget for normal shop costs for the actual products billed, an additional schedule is prepared showing the volume of each class of product, the resulting normal, shop-cost budget, the actual cost of each class of product, and the cost variations.

D. A third section of the report is devoted to statistical information which includes the percentage of operating capacity worked; the under or over absorbed burden, and the manner in which indirect expense variations from the budget contributed to it; and changes in manufactured inventories. Most of this data is reported in greater detail elsewhere but is stated here in summarized form to assist in preparing the overall picture.

Now let us review the information that is available from this report and the significance of it. In the first column is shown the income objective accountable. But the second column adjusts that objective and may hold the Works accountable only for conforming to this adjusted pattern. If, for example, bookings previously have been less than quota, the reduced profit from the lower volume may be attributable to the sales division; or if greater proportions of less profitable business have been booked they will when billed also adversely affect results in spite of adequate controls over shop costs. Generally, the difference between the budgeted income in the fixed and in the variable budget columns is the premium or penalty for different volumes and kinds of products from those provided for in the quota. The difference between the variable budget and actual result is the responsibility of the Works management so far as shop cost and gross trading profit variations are concerned, but with one possible exception. Sometimes the same products are sold both to consumers and through dealers. If the net price after dealer discounts are treated as billings, then any variation from normal selling methods will change the cost ratio to net billings. In such event the normal shop-cost schedule will bear additional information on the normal amount of dealer discounts and actual discounts allowed in the billings, and the amount of the variation will be deducted from the plant management's responsibility and attributed to the sales division.

Separate reports are made for the month and the period to date. On the lower portion of the form space is provision for footnotes explaining any unusual items included in costs; and a letter analyzing the results and pointing out correctives usually is used to transmit this report and its accompanying schedules.

Reports for Special Situations

In addition to the regular daily, weekly and monthly reports concerning operations of various kinds, special conditions arise, from time to time, on which management may require additional or specialized information for a temporary period. For instance, early in the war, plant managers sometimes showed a hesitancy to employ female help to replace male employees going into service, and, as a result, labor conditions became exceedingly tight. A report was initiated which showed the number of plant employees, listed by sex, on the payroll at the beginning of each week, the losses, the additions, and the number on the payroll at the end of the week. If female additions did not keep pace with male losses, inquiries were instituted. As returning servicemen relieved the situation the report was discontinued. The tendency to continue long working hours, after war-time stringencies had passed, was discouraged, until the habit was eliminated, by detailed reports on overtime. At the end of the war many companies found their overheads expanded in excess of the percentage of increase in labor and materials that occurred during that period. With war-time pressures for production regardless of additional costs, personnel was frequently brought up to a point that could not be sustained under normal economic conditions. With additional personnel go a number or contributary expenses which may average a 20-per cent addition to salaries or wages, and which include such items as payroll taxes, supplies, telephone, supervision, cost of payroll accumulation, maintenance of equipment, and the other expenses that are incurred incidental to carrying employees on the payroll. In three or four years this additional personnel, particularly in the non-productive departments, tends to become merged as an integral part of the organization, and with it all of the incidental expenses. To avoid the delay required for a detailed study of the entire personnel, to focus attention on the need for economies, and to precipitate prompt action, graphic charts with supporting schedules can be prepared somewhat as follows:

For foremen or supervision expense, relate this expense to the total plant production for the first normal year preceding the war period—perhaps the year 1940 as a base. Suppose the ratio was 9 per cent. Now, list the production by quarters from then to the present time. If your experience shows that supervision expense should normally vary approximately one-half with volume changes, show in a second column, alongside each quarter's production, the supervision expense for 1940, plus or minus one-half of the 9 per cent ratio or 4½ per cent of the increased or decreased volume. This will be your supervision expense-bogey, but based on pre-war wages. In a third column list for each quarter the total percentage of general wage increases granted since 1940. Add these percentages to the pre-war expense-bogey and show, in a fourth column, the expense-bogey which has now been adjusted for current volumes and wages. In a fifth column show the actual supervision expense. In a final column show the amount and percentage of difference between the adjusted expense-bogey and the actual cost.

If a chart is then prepared to show the expense-bogey and actual expenses on separate lines and if the space is colored green when expenses are below the bogey and red when expenses are in excess, we then have an effective visualization which indicates expenses have been inflated by other than external forces. By varying the bogey with production as normal experience dictates, the same kind of tabulation and chart may be prepared for each type of expense. For instance, clerical expense may vary two-thirds with production; guards and watchmen may vary not at all; some types of other labor and contributary supplies may vary directly with production. Supply accounts will be adjusted by general, material price increases, while maintenance will be adjusted by the weighted average of the proportions of labor and materials that go into it.

After each major class of expense has been scheduled and charted they can be consolidated to show one over-all, plant-expense computation. The result is an approximation of the inflation of total plant expenses, due to other than production volumes and general wage and material price increases. This becomes the reduction objective, allowing, of course, for certain physical changes in the plant which might modify the use of the formula. For instance, one plant manager, using such a set of tabulations and charts earlier this year, reported a couple of weeks ago that 80 per cent of the apparent inflated costs could be reduced (slightly more than half the reduction had already been effected), and that the remaining 20 per cent was due to either additional physical properties or required further studies for final determination. Such reports can be continued until the abnormal, war-time operating practices are reconverted to normal, peace-time methods. Afterwards the reconversion budgets, set on the revised, economical basis, will serve the purpose and these special reports may be eliminated.

General Rules

At the risk of appearing trite, some observations should be made regarding the types of reports for management. Here is a list of factors to remember.

Timeliness is a prime essential because it minimizes lag in applying corrective measures. It is better to supply, through best available estimates, some relatively minor information which is missing, than to defer preparation of the report to a later date.

Reports should be designed for the individuals who are to use them. Although accounting techniques and terms are essential for the accumulation of much of the required data, they should be avoided in the preparation of reports for non-accounting personnel. Most shop men are not interested in debits or credits or in four-figure decimals.

Graphs alone, or supplementing tabulations, can be used effectively for certain purposes, but they must be kept simple. The use of four or more lines to indicate various trends may be difficult to follow by the inexperienced reader.

Never accumulate data or prepare a report unless it has a definite purpose or use whose value is greater than the cost of preparation.

When a report is to be initiated, in order to prevent duplication, see whether the information is available from some existing source. Avoid showing the same detailed information on two different reports; make one serve both purposes.

Periodically review all existing reports and the data accumulated for them, and question whether the condition that caused their initiation still exists. Eliminate them ruthlessly when they are no longer necessary.

Reports must always have management's objectives in view. They should be developed to state those objectives, and to show the progress in their attainment. In brief, good reports are an integral part of good management.

CONFERENCE ROSTER

ACKERMAN, J. E., The Ferro Machine and Foundry Company, Cleveland
ALFORDSON, H. W., Columbus
ALLAN, MABEL, Department of Accounting, The Ohio State University, Columbus
ALLISON, FRANK, Columbus
ALLKART, R. D., The Ferro Machine and Foundry Company, Cleveland
AMICI, ANGELA, Department of Accounting, The Ohio State University, Columbus
ANKERS, RAYMOND G., Lybrand, Ross Brothers and Montgomery, New York, New York
ANSEVIN, A. M., The Champion Company, Springfield
AREND, CARL A., American Rolling Mill Company, Middletown
ARNOLD, FRANK A., Arnold, Hawk, and Cuthbertson, Dayton
ARTHUR, ROBERT K., The Standard Register Company, Dayton
ASSION, LEE T., The Buckeye Steel Castings Company, Columbus
ATCHISON, WILLIAM A., Student, The Ohio State University, Columbus
ATKINSON, HERSCHEL, Ohio Chamber of Commerce, Columbus
ATKISSON, CURTIS T., Ebasco Services, Incorporated, New York, New York
AUSENHEIMER, WALTER E., The McBee Company, Athens
AUSTIN, R. E., Westinghouse Electric Corporation, Cleveland

BAIN, GEORGE J., Yardley Industries, Columbus
BAKER, CHESTER L., Kurz Kasch, Incorporated, Dayton
BALDWIN, JESSE H., C.P.A., Columbus
BALL, ELSIE M., Buckeye Furnace Pipe Company, Columbus
BALLASH, W. H., The Dobeckman Company, Cleveland
BARNES, WALTER C., Moraine Products Division, General Motors Corporation, Dayton
BATTELLE, DON D., Battelle and Battelle, Dayton
BATTELLE, GORDON S., Battelle and Battelle, Dayton
BATTELLE, L. G., Battelle and Battelle, Dayton
BAYER, FRANK, Battelle Institute, Columbus
BECK, RICHARD R., Owens-Illinois Glass Company, Toledo
BECKER, G. ROBERT, Capital Finance Corporation, Columbus
BECKERT, RALPH F., Department of Accounting, Ohio University, Athens
BELL, DOYT E., The Bonney-Floyd Company, Columbus
BENNETT, ARTHUR B., Union Fork and Hoe Company, Columbus
BENNETT, HUGH M., Columbus
BENNINGER, LAWRENCE J., Department of Accounting, Bowling Green State University, Bowling Green
BERTRAM, F. R., Ohio Locomotive Crane Company, Bucyrus
BEST, LEONARD H., The Charles Sucher Packing Company, Dayton

Betsch, W. D., The Ohio Fuel Gas Company, Columbus
Bissell, L. H., Arnold Hawk and Cuthbertson, Dayton
Blackburn, S. C., Armco, Zanesville
Bliss, C. W., Warner and Swasey Company, Cleveland
Boland, Frank A., Keller, Kirschner, Martin and Clinger, Columbus
Boland, J. R., Joyce Products Company, Columbus
Bolon, D. S., Department of Accounting, The Ohio State University, Columbus
Bowersock, Roy E., Wideman, Madden, Dolan and Company, Toledo
Bowyer, A. Lee, Owens-Illinois Glass Company, Toledo
Boyle, J. M., The National Cash Register Company, Dayton
Brinkman, Harry H., Keller, Kirschner, Martin and Clinger, Columbus
Brixner, Edna, The George Worthington Company, Cleveland
Bromfield, Louis, Malbarr Farm, Lucas
Brown, James E., The Cooper-Bessemer Corporation, Mt. Vernon
Bryan, Fred H., Battelle and Battelle, Dayton
Buccalo, James N., Keller, Kirschner, Martin and Clinger, Columbus
Burgeson, E. E., Burgeson and Packer, Youngstown
Burnham, W. C., Department of Accounting, The Ohio State University, Columbus
Butler, Seward, U. S. Engineers, Ohio River Division, Columbus

Calhoon, William R., Arnold, Hawk and Cuthbertson, Dayton
Callahan, Frank C., Richard Smethurst and Company, Cincinnati
Carey, John L., Secretary, The American Institute of Accountants, New York, New York
Caric, J. C., The Cussins and Fearn Company, Columbus
Chapman, R. M., Student, Ohio University, Athens
Chesney, Arthur C. Jr., The Charles Sucher Packing Company, Dayton
Clark, Eleanor M., Marion A. Frye, C.P.A., Cleveland
Clinger, Ralph H., Keller, Kirschner, Martin and Clinger, Columbus
Cochran, C. S., The Champion Company, Springfield
Cochran, William A., Cochran, Huffman and Weir, Cleveland
Coffin, M. D., Owens Brush Company, Toledo
Collinson, J. B., Chakeres Theaters, Incorporated, Springfield
Conroy, Dorothy, Robert N. Lloyd, C.P.A., Dayton
Cook, F. S., Willman Engineering Company, Cleveland
Cook, Margaret, Student, Ohio State University, Columbus
Cooke, Gilbert W., Bowling Green State University, Bowling Green
Cooper, T. Kenneth, Owens-Illinois Glass Company, Toledo
Cotton, Earl E., Thew Shovel Company, Lorain
Covert, M. C., White-Haines Optical Company, Columbus
Cox, R. C., Department of Accounting, The Ohio State University, Columbus
Cranston, H. M., Owens-Corning Fiberglas Corporation, Toledo
Crites, Dean O., Ohio State Department of Taxation, Columbus
Crossley, Leonard L., The Brush-Moore Newspapers, Incorporated, Canton
Curl, John W., Keller, Kirschner, Martin and Clinger, Columbus
Cuthbertson, Harry W., Arnold, Hawk and Cuthbertson, Dayton

DALLAS, MRS. J. E., Arnold, Hawk and Cuthbertson, Dayton
DANIELS, GEORGE A., Hydraulic Press Manufacturing Company, Mt. Gilead
DAVIS, C. X., Battelle and Battelle, Dayton
DAVIS, HARVEY H., The Ohio State University, Columbus
DAVIS, J. L., The H. C. Godman Company, Columbus
DEARDORFF, V. H., The Univis Lens Company, Dayton
DEIBEL, WILLIAM H., JR., Ernst and Ernst, Columbus
DEMPSEY, JOHN M., Moraine Products Division of General Motors Corporation, Dayton
DICKERSON, T. M., Division of Business Administration, Western Reserve University, Cleveland
DICKERSON, W. E., Department of Accounting, The Ohio State University, Columbus
DOMIGAN, HORACE W., Keller, Kirschner, Martin and Clinger, Columbus
DONHAM, RICHARD, Price, Waterhouse and Company, New York, New York
DOWNEND, PAUL E., The Ohio Locomotive Crane Company, Bucyrus
DRAKE, JOHN F., Wolthall and Drake, Cleveland
DU BRUL, KEVIN, United Steel Fabricators, Incorporated, Wooster
DUFFY, ROSEMARY, Student, The Ohio State University, Columbus
DUNDON, ROBERT T., Columbus Store Company, Columbus

EAGLESON, DALE R., Arnold, Hawk and Cuthbertson, Dayton
EBERLY, DALE R., Arnold, Hawk and Cuthbertson, Dayton
ECKELBERRY, G. W., Department of Accounting, The Ohio State University, Columbus
ELSNER, CHARLES F., Ohio Public Service Company, Cleveland
ESSIG, ROBERT R., Army Exchange Service, Fifth Service Command, Fort Hayes, Columbus
EYERMAN, R. F., Norman Products Company, Columbus

FELDMAN, DEVERA, Student, The Ohio State University, Columbus
FENNER, J. B., Electric Auto-Lite Company, Toledo
FENZEL, W. H., Departments of Accounting and Economic Geography, Ohio University, Athens
FICOCELLA, PHILIP A., Keller, Kirschner, Martin and Clinger, Columbus
FINDLAY, M. W., The Warner and Swasey Company, Cleveland
FINDLEY, FLOYD R., International Business Machines Corporation, Toledo
FLEIG, WILFRED J., Department of Accounting, The Ohio State University, Columbus
FLYNN, THOMAS D., Arthur Young and Company, New York, New York
FLICKINGER, C. L., The Deming Company, Salem
FOGT, E. R., Monarch Machine Tool Company, Sidney
FOLK, S. G., The Thew Shovel Company, Lorain
FORBES, WARNER, Miamisburg Paper Company Division, Miamisburg
FORD, RUTH, Keller, Kirschner, Martin and Clinger, Columbus
FORSYTHE, W. GUY, Keller, Kirschner, Martin and Clinger, Columbus
FOUSE, EDWIN L., Denison Engineering Company, Columbus

FRANKE, NORMAN, Gilmanton Salesbook Company, Cleveland
FRANKLIN, CARL, The Ohio State University, Columbus
FRANZ, GORDON K., The Specialty Papers Company, Dayton
FRAVERT, HARRY J. W., Ernst and Ernst, Dayton
FRICKEY, R. N., Pioneer Mutual Casualty Company, Columbus
FRIEDLI, F. EMMETT, Edmont Manufacturing Company, Coshocton
FRIEDLY, MAURICE M., Moraine Products Division, Dayton
FROWNFELTER, R. S., Warner and Swasey Company, Cleveland
FRYE, LOU S., H. C. Godman Company and Subsidiaries, Columbus
FRYE, MARION A., C.P.A., Cleveland
FURRY, VIRGIL L., Columbus Coated Fabrics Corporation, Columbus

GABELE, R. F., Peat, Marwick, Mitchell and Company, Cleveland
GADNEY, EUGENE, Arnold, Hawk and Cuthbertson, Dayton
GAIER, RAYMOND H., Counts and Gaier, Springfield
GARDNER, MARILYN, Student, The Ohio State University, Columbus
GENUNG, PAUL K., Student, The Ohio State University, Columbus
GETZ, HOMER, The American Rolling Mill Company, Middletown
GIBSON, JAMES J., The Dayton Building and Savings Association, Dayton
GILLESPIE, WILLIAM H., Student, The Ohio State University, Columbus
GLAS, MILTON, Columbus
GLEASON, R. W., The Thew Shovel Company, Lorain
GLEIM, D. W., Ernst and Ernst, Columbus
GLOS, R. E., Dean, School of Business Administration, Miami University, Oxford
GLOVER, A. M., Battelle Institute, Columbus
GOBEL, RALPH H., Columbus
GORSUCH, WILLARD, Richard Smethurst and Company, Cincinnati
GOULD, ALLAN B., The Bauer Brothers Company, Springfield
GREINER, SYDNEY, C., Wideman, Madden, Dolan and Company, Toledo
GRIESS, WILLIAM E., Ernst and Ernst, Cincinnati
GRIFFIN, HENRY A., The Hermann Manufacturing Company, Lancaster
GRIFFITHS, H. H., Warner and Swasey Company, Cleveland
GRIM, R. W., Owens-Illinois Glass Company, Toledo
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